Banka Slovenije
The Bank of Slovenia

REPORT ON SUPERVISION OF BANKING OPERATIONS IN THE YEAR 1997 AND THE FIRST HALF OF 1998

December 1998

MISSION

Through effective supervision the Bank Supervision Department fosters sound and transparent operations of the banks.

OBJECTIVES

As bank supervisors we strive to promote principles of prudent banking in banks and savings banks. However, we are not in the position to shelter depositors from hazards, although we foster safe and sound banking operations and stimulating competition. The Bank Supervision Department is not to make decisions instead of owners of banks and savings banks, and bank supervisors are not to cross the line fencing the field of responsibility of the management. Resorting to decrees, guidelines, and recommendations, we try to give our contribution both to expanding the range of services and to offering more sophisticated products, thus stepping up competitiveness while spreading high ethical principles throughout the banking industry and at all levels of decision-making. Regular open communication between the Department on the one hand, and the banks and savings banks on the other, shall remain a cornerstone of our relationship.

ROLE OF INTERNAL AUDITORS

In the light of the importance of the internal auditors for a continuing and untroubled prosperity of the banks, coupled with the growing awareness of the external auditors how really significant the role of their in-house colleagues is, we wish to summarise the tasks these professionals are entrusted with.

Effective internal control systems and the wheels of internal audit turning smoothly are essential elements of performance benchmarking and proper risk management eventually leading to less uncertainty in each bank.

It should not come as a surprise that the notorious cases of bank crises have been accounted for as the results of inadequate and incomplete internal controls and the absence of proper internal audit. Furthermore, external auditors blame the inefficient internal audit and the flawed system of internal controls of an ailing or a failed bank for the bank's woes and have to report on such disclosures when issuing the opinion on the financial statements of such a bank.

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1. DEVELOPMENT OF BANKING SUPERVISION

1.1. Core Principles for Effective Banking Supervision

A comprehensive set of principles for banking supervision, the Core Principles for Effective Banking Supervision, also referred to as the Basle Core Principles, issued in September 1997 by the Basle Committee on Banking Supervision[1], will shape the future of banking supervision all over the world.

The twenty-five principles promulgated by the Basle Committee enable bank supervisors to remain in the mainstream of the globalisation of financial services where traditional banking, brokerage, and insurance business, as well as other types of agency business, mix and spill over state border. By increasing the number of countries prepared to abide by the Basle Core Principles, the institutional supervisory competence of banking supervisors will be strengthened, and the pre-requisites for liaisoning with other regulators for financial markets will be fulfilled. We believe that the call for collaboration between all regulators and supervisors of financial markets spelled out in the Basle Core Principles for Effective Banking Supervision, encapsulates the foundations for constructing stronger links between authorities and possible institutional unification.

Following its debut in April 1997, the Core Principles for Effective Banking Supervision had first to get a clean bill of health from representatives of Group-of-ten (G-10) countries and fifteen emerging market countries. Thus a forum was provided for the exchange of experiences and the identifications of fields requiring particular efforts. Representatives from member states serving on other committees were also invited to contribute to the work of the Basle Committee, as banking supervisors also sit on some eleven committees organised on geographical/regional basis. Slovenia is a member of the Group of Banking Supervisors from Central and Easter Europe. So, responding to the need for the harmonisation of banking regulation, the Core Principles for Effective Banking Supervision developed through a collaborative process between supervisory authorities were officially presented at the IMF Conference in Hong Kong, some five months later.

The Basle Core Principles comprise 25 principles setting forth minimum standards for the implementation of effective banking supervision, leave national authorities room for fine tuning and thus stand a fair chance to be endorsed and implemented.

[1] The Basle Committee on Banking Supervision is a Committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1995. It consists of senior representatives of banking supervisory authorities and cental banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom and the United States.

1.1.1. The impact of Basle Core Principles for Effective Banking Supervision on banking operations

The Basle Core Principles for Effective Banking Supervision are considered as the mainstay of banking supervision and the elaborate guidelines for their implementation make them especially valuable. A reason more for all supervisory authorities to embrace the principles as the standard for supervision lies in the fact that all issues pertaining to effective banking supervision were discussed at practically all forums of banking supervisors who played a proactive role and made recommendations to the Basle Committee.

In practice, the implementation of the Basle Core Principles is considered to constitute the standard for effective banking supervision, and may be regarded as the cornerstone of a trustworthy banking system.

From the legal point of view, the Basle Core Principles are standards not binding upon a country. Therefore, should the competent authorities of each country decide to implement the Core Principles or not, is entirely up to them.

There are many signs indicating that the Basle Committee for Banking Supervision will see to the widest possible implementation of the Core Principles. The Core Principles Liaison Group, to work alongside a larger Core Principles Consultation Group, has been established to promote the implementation of the Core Principles and discuss more problematic issues arising from the implementation of individual principles. In co-operation with the World Bank and the International Monetary Fund, and by resorting to enforcement mechanisms deployed by these institutions, the Basle Committee will ensure full support to the Core Principles, as well as their official acceptance, and the oversight over their implementation.

The overall effect on banking industry will be twofold. Firstly, each bank that emerges in the market anywhere in the world, will have to meet the minimum requirements of the environment infrastructure and to comply with the standard followed by banking supervisors. On the other hand, each bank will be subject to minimum supervision criteria regardless of its place of business. Thus the potential risks associated with its operations will be diminished.

1.1.2. The impact of Basle Core Principles for Effective Banking Supervision on other financial institutions

Although the Core Principles have been designed having in mind banks, a few apply to financial institutions as well. Pre-requisites required for sound banking business and effective supervision set up with the aim to ensure the soundness of operations, are valid for all providers of financial services. It must be admitted, however, that some standards for prudential operations are indeed closely associated with certain features typical of banks only, thus limiting the scope of application exclusively on banks. Such principles can be counted on the fingers of one hand. Most Core Principles contain, however, general banking standards to be used beyond banking industry in the narrow sense of the word.

1.1.3. Basle 25 Core Principles for Effective Banking Supervision

The Governing Board of the Bank of Slovenia endorsed the Core Principles for Effective Banking Supervision at the session held on 23 June 1998 as the guidelines of utmost importance for the Bank Supervision Department operating within the framework of the Bank of Slovenia. The Bank Supervision Department is committed to implement the principles which have already been complied with (Principles Nos. 2, 3, 4, 6, 7, 8, 9, 11, 12, 14, 15, 16, 17, 19, 21, and 22), as well as to duly implement other principles once the new Banking Law and the secondary legislation to be promulgated has been passed.

Principle 1

An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organisations. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking organisations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

The new Banking Law, as well as the collective agreement of the Bank of Slovenia, comprise fundamental legal safeguards to protect bank supervisors in the case of a lawsuit filed against him. Well-constructed legal framework appears to be of paramount importance, as the essential case processing elements are incorporated in the Law with the aim to shelter supervisors.

Principle 2 (complied)

The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word "bank" in names should be controlled as far as possible.

Principle 3 (complied)

The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organisation's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

Principle 4 (complied)

Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.

Principle 5

Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

The Bank of Slovenia does not prescribe special criteria for the assessment of the grounds for the capital investment of a particular bank. The new Banking Law does foresee, however, a possibility that the Bank of Slovenia reviews directly corporate affiliations of the bank. By exercising its authority to approve the acquisition of the qualifying stake in a bank, the Bank of Slovenia prevents the creation of corporate affiliations that could threaten principles of safe and sound banking operations or hinder effective supervision.

Principle 6 (complied)

Banking supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the Basle Capital Accord and its amendments.

Principle 7 (complied)

An essential part of any supervisory system is the evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.

Principle 8 (complied)

Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan loss reserves.

Principle 9 (complied)

Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

Principle 10

In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

Exposure associated with connected lending is addressed in the Banking Law bill by treating connected persons as a client when the bank's exposure is defined.

Principle 11 (complied)

Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.

Principle 12 (complied)

Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

Principle 13

Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior - management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.

Banks have been stepping up efforts to set up a proper and systemic risk management process as a part of their activities aimed at addressing recommendations issued by the Bank of Slovenia. These efforts target various forms of exposure inherent in banks' operations. The bill of the Banking Law clearly sets forth provisions requiring banks to set up and implement on a systemic basis processes to measure and control all risks, and to hold capital adequate to cover potential losses arising from such risks.

Principle 14 (complied)

Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

Principle 15 (complied)

Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

Principle 16 (complied)

An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

Principle 17 (complied)

Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operations.

Principle 18

Banking supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis.

The bill of the Banking Law vests the Bank of Slovenia with authorisation to supervise banking groups on consolidated basis including gathering, examining and analysing all data and information needed for consolidated supervision.

Principle 19 (complied)

Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.

Principle 20

An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.

Consolidated supervision is one of most important novelties introduced under the bill of the Banking Law. Under the new approach, the Bank of Slovenia is vested with power to supervise a bank - member of a banking group - on the basis of consolidated statements showing the financial position of the banking group.

Principle 21 (complied)

Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

Principle 22 (complied)

Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking licence or recommend its revocation.

Principle 23

Banking supervisors must practice global consolidated supervision over their internationally-active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.

The bill of the Banking Law provides legal framework for the Bank of Slovenia to supervise branches of Slovenian banks in foreign countries. The supervision of subsidiaries of Slovenian banks is provided for under the accreditation for the consolidated supervision of banks.

Principle 24

A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

By incorporating accountability for safeguarding confidential data into the bill of the Banking Law, the pre-requisite for the collaboration between the Bank of Slovenia and supervisory authorities in foreign countries, as well the exchange of information, has been fulfilled.

Principle 25

Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

The Bank of Slovenia will be authorised to review also business operations of branches of foreign banks operating in Slovenia in order to check whether prudential risk management principles and other provisions laid down in the new Banking Law are observed.

1.2. The importance of an effective internal control systems

Provided the system of internal controls is defined as systematically incorporated processes and methods set up by management of the bank with the aim to ensure on-going business operations, adherence to business policies, necessary safeguards, completeness, correctness and reliability of accounting records, as well as the preparation of true and fair financial statements, reducing the possibility of errors and fraud and early detection of irregularities in banking operations, then constant supervision of the internal controls function is one of preconditions for prudential, safe and effective operations. As testing the adequacy of internal control systems is in the mainstream of the activities falling in the province of work of the internal (and external) auditor, the Bank of Slovenia has repeatedly sounded a warning as to the importance of an effective system of internal controls. The responsibility for putting in place internal control systems rests with the bank's management. Internal control systems oversight is in the hands of the internal auditor.

A case in point is that the internal controls mechanisms are set up and running. The motive for putting in place and maintaining a comprehensive and productive internal control systems lies in the necessity to manage risks. Business operations are exposed daily to all sorts of risks and the need to curb those risks calls for sophisticated and versatile internal control systems. Risk control shall also be the responsibility of senior management that has to ensure that the bank draws up a strategy for risk management. Due to the complex nature and sensitivity of the issues, efforts of managers at all levels have to be synchronised, and knowledge and skills of professionals working in the bank on related matters pooled.

To assess the adequacy and efficiency of a system of internal controls is in the limelight of examinations carried out by examiners of the Bank of Slovenia when full-scope operations controls are made. Nevertheless, this field will have to be scrutinised with even more care in the future, especially in the light of the full implementation of the Basle Core Principles, and above all, Principle 14 which deals with internal controls function.

In the light of Principle 14, the role of bank supervisors becomes even more important as it is their task to verify if the internal control systems are properly scaled for the scope and the nature of operations of a particular bank. Should bank supervisors establish that the internal controls system is inadequate, they are to take necessary steps and instruct the bank to bring about timely corrective action.

1.3. The role of banking supervision of the Bank of Slovenia

1.3.1. Strategic plan for the promotion of effective banking supervision

In September 1995, the Governing Board of the Bank of Slovenia endorsed the Strategic Plan for Banking Supervision for the period between 1995 and 1999. The Strategic Plan addressed short- and long-term targets for effective supervision of banking operations.

To ensure ongoing quality supervision across the banking industry without losing sight of individual members of the banking system, ranks right on top of the tasks carried out by the Bank Supervision Department of the Bank of Slovenia. This comprehensive task is considered to be the most efficient way to keep the inflow of timely information on the developments that may produce adverse effects at the level to enable taking necessary actions. Only through constant bankwatch it is possible to safeguard banks' depositors and avert banking crisis.

Prudential regulations, requirements and guidelines referring to specific business areas help to promote the principles of safe and sound banking. By exercising their function, bank supervisors promote the concept of responsibility for risk control to be shared by directors and senior bank officers, but also the awareness of the need to set up efficient internal controls, procedures and reporting system - all with the aim to sustain profitable and safe operations.

Under the schedule of examinations within the framework of ongoing banking supervisions, a full-scope on-site examination is carried out in each bank not less than once in every two years, independently of regular off-site examinations of its returns submitted to the Bank of Slovenia. The CAMEL system[2] has been selected, and a complementary system of analytical assessment of collected data has also been developed to help interpret the dry language of figures, and bank rating.

Proper evaluation of gathered information and fair assessment of the overall situation across the banking industry and in all its segments, will help make projections and eventually divert the course of events threatening the stability in the sector.

In spite of initial difficulties encountered during the first three years of the implementation of the Strategic Plan for Banking Supervision, significant improvements have been achieved. The so-called four-eye-principle has been implemented, meaning that both analysts and examiners are responsible for monitoring banks and savings banks. The number of banks and/or savings banks supervised by one analyst-examiner team, depends on the size of the respective bank/savings bank.

The role of analysts in the Bank of Slovenia is to take part in the assessment of operating results of banks and savings banks. They are also involved in granting licences and approving proposed changes, they test new system solutions, advise on implementation of principles for prudential and safe operations. Analysts monitor

[2] C stands for capital, A stands for asset quality, M stands for management, E stands for earnings, and L stands for liquidity.

constraints imposed with the aim to ensure safe and prudential operations, and they monitor profitability on regular basis by scrutinising statutory returns and other information at least once a month. Should any irregularities be discovered in operating activities of banks and/or savings banks, they take remedial actions and keep a watchful eye on the actual implementation of such remedial actions. In addition, analysts participate in the preparations for examinations to be carried out in banks and/or savings banks, and they sit in meetings held with the representatives of banks and/or savings banks being under the looking-glass, as well as meetings held with other institutions. Intimate knowledge analysts have about various aspects of the banking industry at home and abroad is disseminated through reports and other materials prepared for the departments of the Bank of Slovenia, the Governing Board, and other institutions, often beyond the boundaries of Slovenia. And the last, but not the least task of an analyst is to pass on the information on any irregularity detected to the competent examiner who will decide whether an on-site examination is necessary or not.

On-going supervision of banks and savings banks has been ensured by means of statutory reports regularly submitted to the analysts of the central bank. Alongside the thorough off-site examination, on-site examinations are a valuable supervisor's tool. Full-scope examinations are carried out annually in up to fifteen banks and savings banks. Target examinations focusing on one or more segments of banking operations are carried out in some twenty banks and savings banks. Although a full-scope examination of a bank or a savings bank is scheduled to take place at least once every two years, quick identification of risky areas lead to target examinations undertaken in banks and savings banks at least once a year. Risks associated with information technology frequently trigger target examinations.

Within overall efforts to improve standards in the Slovenian banking sector, managing directors or members of management of banks and savings banks are summoned to meetings at least once a year either at the completion of the full-scope examination, or simply to discuss a specific topic. The idea is to assess better the current position of the respective bank or savings bank, and to obtain first-hand information regarding its development strategy. The exchange of opinions and information between bank supervisors/regulators and top management is a precondition for timely and appropriate reaction in case a bank or a savings bank becomes problematic in any aspect whatsoever. By addressing problems without delay, and by monitoring actions taken to remedy the situation, benchmarking the compliance of the delinquent bank or savings bank becomes more efficient, and more painful consequences may be averted.

During the past three years, the volume of secondary legislation prepared in the Bank of Slovenia may be taken as an indicator of the commitment of all its departments, but in particular of the Bank Supervision Department, to promote effective banking supervisions by issuing not only new regulations, but also amendments and instruction for the implementation of prudential rules. The Bank of Slovenia continued collaboration with the Ministry of Finance in drafting the bill of the Banking Law. The provisions of the new Banking Law will converge with the Directives adopted by the European Union. As it is expected that the new Banking Law will be promulgated in the first quarter of 1999, and as the Bank of Slovenia will have only three months from the entry into force of the new Banking Law to pass secondary legislation, several by-laws are already in the pipeline.

1.3.2. Organisational structure of the Bank Supervision Department

The Bank Supervision Department was established within the framework of the Bank of Slovenia in the beginning of April 1992. The staff counting fifteen employees upon the establishment rose to thirty-seven in June 1998, just one employee more than in the beginning of 1997. At the end of June 1998, three people were at the first organisational level, off-site supervision had seventeen people including the head of the unit, on-site supervision headcount was fifteen, and licence granting unit had two employees on the payroll at the end of the period under review. Once the new Banking Law has been promulgated, the Bank Supervision Department will take over new tasks such as supervising savings co-operatives, supervision on consolidated basis (full solo-plus approach), etc. The extended scope of work will call for the expansion of human resources in the Bank Supervision Department.

In addition to personnel policy that promotes the principles of integrity and dedication, it should not come as a surprise that in the Bank Supervision Department which employs twenty-eight persons with university degree, particular attention is paid to training. Experienced professionals with proven capability to face new challenges and cope with ever-increasing requirements imposed in the business environment are recruited to the ranks of the Bank Supervision Department. Pinpointed is the combination of hands-on experience with theoretical knowledge acquired either at advanced academic studies or through tailored programmes in particular fields. Accessing, assimilating and leveraging competencies and knowledge from around the world has generally taken place at seminars, workshops and conferences at home and abroad, complemented by working visits to foreign institutions, and by hosting visiting experts.

Alongside in-house training programmes delivered by both local and foreign lecturers, the staff of the Bank Supervision Department have attended training programmes organised by the Bank Association of Slovenia, the Centre for Professional Training and Consulting of the Faculty of Economics at Ljubljana University, the Slovenian Institute of Auditors, the Institute for Corporate Law, computer and foreign language courses, etc. Outside Slovenia, the employees of the Bank Supervision Department have taken part in seminars and workshops organised by the Bank of England, Deutsche Bundesbank, Banque de France, Federal Reserve Bank of New York, Joint Vienna Institute, L'Institut de Formation Bancaire from Luxembourg, International Faculty of Finance from London, and practical training in Commerzbank and Deutsche Bank.

1.3.3. Tasks of the Bank Supervision Department

Licence granting:

- Preparation of secondary legislation regulating granting licences and authorisations,
- Advising on the implementation of secondary legislation regulating granting licences and authorisations,
- Processing applications and preparation of reports on licences and authorisations granted,
- Drafting decisions to grant a licence and explaining grounds for the decision,
- Follow-up of the enforcement of the issued decisions, decrees, etc.

Off-site supervision of bank operations:

- Drawing up the legal framework for the supervision of banks and savings banks,
- Implementation of recommendations made by relevant international institutions,
- Counselling on the enforcement of the legislation regulating the area of finance,
- Preparation of instructions on how to apply accounting standards and advising in the field of accounting,
- Supervision of the operating activities of banks and savings banks based on controlling statutory returns, reports and other documents submitted,
- Implementing measures to correct malfunctioning in the operating activities of banks and savings banks and following the corrective action,
- Analysing results of business operations of banks and savings banks,
- Co-operation with external domestic and international institutions,
- Participation in the preparations for on-site examinations in banks and savings banks,
- Legal counselling,
- Electronic data processing and other related services.

On-site supervision of bank operations:

- Preparatory activities leading to on-site examination based on reports and other statutory returns submitted by banks and savings banks available in the Department,
- Direct checks of business operations of banks and savings banks,
- Measures taken in order to remedy irregularities found in business operations of banks and savings banks,
- Follow-up of the enforcement of corrective measures taken against banks and savings banks,
- Advising within on-site supervision function on the way to improve operations of banks and savings banks,
- Close watch on banks and savings banks,
- Co-operation with foreign auditors and chartered accountants,
- Identifying the situation that calls for instituting bankruptcy procedure in a bank,
- Enforcing pre-rehabilitation measures in banks and savings banks,
- Preparation of assessment of the financial position of banks and evaluation of the economical justification of rehabilitation,
- Placing banks in the bank rehabilitation procedure,
- Identifying the conditions required to institute liquidation proceedings against a bank or a savings banks,
- Governing and managing banks in special cases, etc.

1.3.4. On-site examinations and corrective actions

In the course of 1997, the examiners of the Bank Supervision Department carried out thirty-three examinations of operations of banks and savings banks. In thirteen cases it was a full-scope examination, and in twenty cases it was a target examination. Routine random controls were conducted in twenty-three banks and eight savings banks. One savings co-operative was subject to such a control, while checking of activities of the Slovene Export Corporation was carried out together with the Insurance Supervisory Authority.

In the first and second quarter of 1998, sixteen banks and savings banks were subject of controls carried out by the examiners of the Bank Supervision Department. A half of these controls involved full-scope examination. There were thirteen controls conducted in banks and three in savings banks.

Having responded to the request expressed by the Slovenian Export Corporation d.d. Ljubljana, a segment of operations of that institution was examined in the first half of 1998, particularly with regard to information technology.

Since 1996, examinations targeting information technology have been going on as scheduled - both within the framework of regular, full-scope examinations, and on its own merit. Save for two banks and one savings bank, all others have already been put under the looking-glass of IT specialist from the Bank of Slovenia.

As banks play a central role in every economy, and the soundness and stability of the banking sector is a matter of wide public interest, banks and savings banks in Slovenia are subject to supervision mainly focusing on the following:

- Capital adequacy,
- Quality of credit and trading portfolio,
- Command of risk management techniques,
- Quality of internal control and audit function, as well as of the internal control systems,
- Quality of earnings,
- Tools available for the maintenance of liquidity, and
- Extent of support provided by information technology to business operations.

Examinations with limited scope - the so-called target examinations - were focused primarily on credit portfolio, trading portfolio, off-balance-sheet transactions, new contractual relations, information technology, and follow-up checks on the implementation of mandatory corrective measures.

External examinations performed in banks and savings banks resulted in spotting malfunctions mainly in the activities listed below:

- Inadequate classification of customers, provisions falling short of mandatory targets, and failure to exclude income (suspend accruals),
- Sub-standard keeping of credit files,
- Flawed mandatory reports sent to the Bank of Slovenia,
- Excessive exposure arising from connected lending,
- Inadequate valuation of risks associated with operational activities,

- Poor organisation of internal control and audit function,
- Book-keeping errors,
- Breaching stipulations laid down in Article 43 of the Law on Banks and Savings Banks (net debtors),
- Vague legal status, Memorandum and Articles of Association and documents deriving therefrom fail to meet mandatory requirements,
- Ineffective information technology.

Several decisions on corrective actions were passed during the period under review, on the basis of findings made by the examiners of the Bank of Slovenia. Furthermore, recommendations were made to banks and savings banks as to adhering to prudential standards in the light of identified exposure and the further development of operating activities.

Regarding IT issues and the "Year 2000" compliance by banking institutions, banks and savings banks have been asked to assess risk associated with information technology and its impact on their respective operations. Additionally, banks and savings banks were to draft "maturity" programmes and state the institution's preparedness for the Millennium. Ample room for improvement is still found in the closer collaboration between management and IT structures, more efficient deployment of IT aimed at reducing operating costs, open-minded approach to innovative processes, stronger relationships with suppliers of goods and services whenever a banking institution relies on outsourcing, boosting activities so that IT-related projects are completed as scheduled, and responding in a timely manner to changes occurring both in the financial and IT industry worldwide. Virtual banking has been developing fast and has already added a new dimension to banking services. As it does not constrain banks to remain within their geographical boundaries, a boom is predicted in electronic commerce as new financial products become accessible to an ever-increasing number of customers. New payment system has made its first steps and regulators are busy drafting standards urgently needed in the banking sector to preserve prudential manner of doing business.

Key elements required in the field of information technology are knowledge, fast decision-making process resulting in proper and timely actions, as well as the successful and efficient implementation of all processes involved not only in the technological aspects, but also in the impact on the entire banking business. To mention just a few factors to be taken into account: research, control and cost-effectiveness, measurement systems and benchmarking, safeguards coupled with enforcement mechanism, total quality management comprising service, information and database, and the last, but not the least, adherence to standards and principles recognized worldwide. Although Slovenia has to catch up with the EU Member States, we monitor cross-border developments and react promptly.

1.3.5. Granting licences and authorisations

In accordance with the Law on Banks and Savings Banks, a threshold for establishing a banks was set at SIT 680 million in cash. The Bank of Slovenia is in charge of issuing unlimited or limited licences for conducting banking operations depending on the amount of the subscribed capital (also referred to as foundation capital) for newly established banks, or depending on regulatory capital for operating banks.

The scope of activities comprised in the unlimited licence (also referred to as full licence) authorising the bank to conduct operations without restrictions is listed in Article 2 of the Law on banks and Savings banks as set forth below:

1. Acceptance of all types of deposits from legal and natural persons,
2. Granting and obtaining of loans,
3. Conducting payment transactions,
4. Redemption of checks and bills of exchange,
5. Transactions with foreign means of payment,
6. Issuance of securities and credit cards,
7. Trading in and management of securities of domestic and foreign issuers,
8. Acceptance and issuance of sureties and guarantees and assumption of other obligations for the account of its clients that can be settled in money,
9. Redemption of claims and forced settlement,
10. Safe-custody of securities and other valuables.

Limited licence for banking activities authorises the bank to conduct only certain banking operations across the whole territory of the Republic of Slovenia, or only in one region.

Banks whose subscribed capital is lower than 1.2 times minimum capital amount required to establish a bank (more than SIT 680 million and less than SIT 816 million), are subject to constraints imposed on the scope of their authorised activities as listed below:

- operations of banks in this group are subject to regional limitations,
- these banks are not authorised to take private foreign exchange deposits,
- these banks are not authorised to open accounts and take deposits from or open custody accounts for foreign persons,
- these banks are not authorised to carry out transactions involving foreign currency,
- these banks are not authorised neither to issue securities in their own name nor credit cards,
- these banks are not authorised to take or issue sureties and guarantees, and they are not to assume any other commitments for account of their clients.

Banks whose subscribed capital is equal to or higher than 1.2 times and lower than 3 times minimum capital amount required to establish a bank (more than SIT 816 million and less than SIT 2,040 million), are subject to constraints imposed on the scope of their authorised activities as listed below:

- operations of banks in this group are subject to regional limitations,
- these banks are not authorised to take private foreign exchange deposits,
- these banks are not authorised to open accounts and take deposits from or open custody accounts for foreign persons.

Banks whose subscribed capital is equal to or higher than 3 times and lower than 6 times minimum capital amount required to establish a bank (more than SIT 2,040 million and less than SIT 4,080 million), are subject to constraints imposed on the scope of their authorised activities as listed below:

- these banks are not authorised to take private foreign exchange deposits,
- these banks are not authorised to open accounts and take deposits from or open custody accounts for foreign persons.

Banks whose subscribed capital is equal to or higher than 6 times minimum capital amount required to establish a bank (more than SIT 4,080 million), are not subject to any constraints on the scope of their authorised activities.

Unlimited (full) licence for banking operations as at 30 June 1998 was in the hands of the same number of banks as on 31 December 1997 - fifteen banks. Full licence for all operations in the filed of commercial and investment banking is held by seven universal banks, while six banks have a licence for all operations in commercial banking, and two banks have a licence authorising them to conduct all commercial

banking operations and certain operations falling in the province of investment banking.

Members of the Governing Board of the Bank of Slovenia decide on granting the following licences and approvals on the basis of the opinion of the Committee of the Governing Board of the Bank of Slovenia in charge of applications and granting of licences for operations of banks and savings banks as set forth below:

- Licence to a bank or a savings bank to conduct banking operations,
- Licence to a foreign bank to set up a subsidiary on the territory of the Republic of Slovenia,
- Licence for mergers and acquisitions involving banks or savings banks, as well as the licence for dissolution,
- Authorisation to a foreign bank to set up a business unit or a representative office,
- Authorisation to an individual domestic founder of a bank or shareholder to acquire more than 15 per cent of voting shares in the bank, i.e. authorising further increase of ownership of the respective bank,
- Authorisation to a foreign person to become the founder of a bank, i.e. authorising further increase of ownership of the respective bank,

- Licence to conduct banking operations falling beyond the scope of the original licence (the so-called additional banking operations), and
- Licence to trade in securities.

The opinion as to the appointment of a managing director, i.e. of members of management is furnished to the Bank of Slovenia by the Committe of the Governing Board of the Bank of Slovenia in charge of endorsing appointment of bank directors.

In the year 1997 and in the first half of 1998, not a single licence was issued to a bank or a savings bank to conduct banking business, to a foreign bank to set up a subsidiary in Slovenia, to a bank or a savings bank for a merger, take-over or dissolution. After a long period, in the first half of 1998, one application for the establishment of a representative office of a foreign bank was filed and approved. In the year 1997, primarily due to the creation of banking groups, most approvals were given to domestic shareholders registering their interest to acquire a stake in a bank exceeding 15 per cent of equity (eleven approvals were granted, while one was withheld). In the first half of 1998, only one such approval was issued. Most approvals given in the first half of 1998 went to foreign shareholders applying for a stake in Slovenian banks (7), which is below 1997 figure (9). As opposed to the year 1997, when four approvals were granted for additional operations to be conducted by banks/savings banks, in the first half of 1998, no bank or savings bank turned to the Bank of Slovenia with a similar request. Trading licence was revoked in three cases in the year 1997, and in one case in the first half of 1998, on the grounds that the banks holding trading licence had teamed up with other banks to create a banking group. In such cases, trading licence is held by one bank - member of the banking group. During the period under review, no trading licence was issued. In 1997, eleven candidates were confirmed as managing director, deputy managing directors or members of management and the mandate of one president and one member of a managing board was extended. In one case only such approval was withheld. In the first half of 1998, six approvals for the appointment of directors, i.e. president and members of management were issued.

1.3.5.1. Banking groups and financial conglomerates

In the year 1997, first banking groups were formed as a headway towards the consolidation of the banking sector. In accordance with the Law on Banks and Savings Banks, a banking group is formed when one bank directly or indirectly acquires at least a 40 per cent stake in the subscribed (foundation) capital of another bank, or if it controls another banks directly or indirectly. In the course of 1997, four banking groups were created:

- Banka Celje banking group, comprising Banka Celje and Hmezad banka d.d. @alec,
- Nova Ljubljanska banka banking group (NLB), comprising NLB, Pomurska banka d.d., Murska Sobota; Koro{ka banka d.d., Slovenj Gradec; Banka Velenje d.d., Velenje; Banka Zasavje d.d., Trbovlje, and Banka Dom`ale d.d., Dom`ale,
- SKB banking group, comprising, SKB and UBK banka d.d., and
- Banka Koper banking group, comprising Banka Koper d.d. and M banka d.d..

Reasons such as enhanced cost-effectiveness of financial services and stiffer competition in the banking sector, but also measures brought about by the Bank of Slovenia, prevail when banks consider joining forces.

The Bank of Slovenia has laid down minimum requirements for the creation of banking groups. Banks - members of a banking group - sign a legally binding contract to reconcile measures of current and development policy in the field of cross-border banking, marketing, developing of new products, information technology, credit operations, ATM network, etc. Risk management policy is also dealt with at the level of the banking group. A bank faced with liquidity problems that has already exploited regular ways to borrow funds in the money market and not eligible for accommodation made available to banks by the Bank of Slovenia, gets necessary funds from other banks - member of the banking group. Terms and conditions of such financing shall be in conformity with terms and conditions previously agreed upon. Should a bank - member of the banking group - be struggling with solvency problems, other member banks shall bring about actions aimed at mitigating solvency risk on terms and conditions previously agreed upon. The parent bank is the leading bank in the banking group and plays a proactive role at all times. The same accounting standards and policies are uniformly and consistently applied on all member banks, while the umbrella internal control and audit function set up along lines of the internal control and audit of the parent bank is responsible for oversight and control of the banking group.

The contract for the accession to the banking group also stipulates that the same external auditor will conduct audit both in the parent bank and in member banks.

In addition to banking groups, financial conglomerates[3] have been operating in the Slovenian business environment for some time already. Therefore, eighteen Slovenian banks and one savings bank have consolidated their financial statements. As in accordance to the effective Law on Banks and Savings Banks, the Bank of Slovenia does not have accreditation to conduct supervision of other companies - members of the financial conglomerate - which are not banks, even though such supervision may be required for the purpose of checking operations of the bank which is a member of the financial conglomerate, the scope of banking supervisions does not go beyond banks and savings banks.

1.3.6. Liaison with supervisory institutions

1.3.6.1. Liaison with domestic supervisory institutions

Universal banking predominates in Slovenia and comprises full-scope operations in the area of both commercial and investment banking. With the aim to implement regulations passed for the financial field, and driven by the need to harmonise segments of the financial system being sometime on the opposite end of the spectrum, the Bank of Slovenia and the Agency for the Securities Market signed the Protocol on Co-operation in July 1996 laying the foundations for harmonised activities primarily with respect to the following:

[3] Financial conglomerates comprise banks, non-bank affiliated undertakings such as leasing companies, real estate agents, managing companies, consulting and other financial institutions.

- Preparation of systematic measures applicable to the core tasks of both institutions, i.e. to the segments of the financial system controlled by both institutions as regulators,
- Granting licences to banks thus qualifying them to act as certified participants on the securities market,
- Controlling the banks authorised as certified participants or issuers of securities on the securities market, whereas the Agency for the Securities Market would exercise control over operations involving securities and the Bank of Slovenia would control operations of the entire bank,
- Exchange of information on related entities regardless the form or manner of association doing business on the securities exchange and/or in commercial banking,
- Exchange of various information the two institutions collect in the routine course of their work which would serve in the preparation of analyses and surveys either institution may need in order to improve efficiency, and
- In all other fields where such collaboration is assessed as potentially useful for better performance of both institutions.

Fast developments in the Slovenian banking industry have blurred the demarcation line between banking and insurance business and some banks are already establishing links with insurance companies mostly by acquiring equity stakes. Therefore, the need to lay grounds for the co-operation between the authority which supervises insurance companies and the Bank of Slovenia resulted in the conclusion of the Agreement on Co-operation between the Bank of Slovenia and the Ministry of Finance - Insurance Supervisory Authority of the Republic of Slovenia in May 1996. The Agreement lays down the framework for the following activities to be carried out:

- Exchange of data and information on the entities falling within the scope of control of the Bank Supervision Department of the Banks of Slovenia and the Insurance Supervisory Authority of the Republic of Slovenia,
- Joint examinations and collaboration in the field of supervision,
- Liaison in other fields where convergence of activities may step up the performance of both institutions.

Joint examinations have already become a routine, as the Bank of Slovenia has co-operated with the Agency for the Securities Market and the Insurance Supervision Authority of the Republic of Slovenia, so joint examinations could also include the Office for Prevention of Money Laundering of the Republic of Slovenia within the framework of the Ministry of Finance. The Bank Supervision Department has successfully co-operated with this Office when supervising banks, savings banks and savings co-operatives with respect to measures put in place with the aim to detect and prevent money laundering, as well as in the area of drafting secondary legislation, training, establishing contacts with money laundering experts etc.

1.3.6.2. Cross-border liaison

The Bank of Slovenia participates as a supervisory authority in all activities of the Group of Banking Supervisors from the Central and Eastern Europe and bank supervisors attend meetings and conferences feeling honoured to contribute to the work of this body. The professionals working for the Bank Supervision Department

also participate in consultations and collaborative processes that will eventually lead to forging new guidelines through intense exchange of opinions as was the case with the Basle Core Principles for Effective Banking Supervision. The commitment to promote bank supervisory principles in Slovenia without lagging behind forerunners in the field has earned enviable reputation to the supervisors of the Bank of Slovenia and also took them to their counterparts in the National Bank of Poland, Czech National Bank, and Hungarian Banking and Capital Market Supervision in 1997 and the first half of 1998.

In the year 1999, the Bank of Slovenia will host for the first time the annual conference of the Group of Bank Supervisors from Central and Eastern Europe, already 12th in a row.

Liaison with foreign supervisory authorities in the field of banking supervision has not been formally sanctioned despite efforts on the part of the Bank of Slovenia. Official arrangements for on-going communication with central banks which supervise branches and subsidiaries of Slovenian banks abroad have to be made. Valuable input has already been acquired through contacts with some European supervisory institutions - Commission Bancaire and the Banque de France, De Nederlandsche Bank, Banco d'Italia, Deutsche Bundesbank and Landeszentralbank im Freistaat Bayern, Banking and Finance Commission in Belgium, Banco de Portugal, Bank of England, Central Bank of Ireland, Finanstilsynet, Oesterreichische Nationalbank - and FED, as well as the World Bank.

Since Slovenia is an associated member of the European Union, bank supervisors from Slovenia have attended meetings of the Sub-Committee on Financial Services & Establishment within the framework of the European Commission. In addition, Slovenian supervisors have participated in talks with the missions of the World Bank and the International Monetary Fund, as well as in a series of informative visits of the representatives of rating organisations and have met with many foreign visitors.

1.3.7. Liaison with auditors

Financial statements of the Slovenian banks were audited for the financial year ended 31 December 1997 by three registered auditors/chartered accountants: Coopers & Lybrand, d.d. in most banks, KPMG Slovenija, d.o.o. in one bank, and Deloitte & Touche, d.o.o. in two banks. Audit in all savings banks was conducted by ITEO-Revizija d.o.o. Ljubljana (registered auditing company).

Auditors' opinion on all banks and savings banks is positive, i.e. in their opinion, the financial statements of Slovenian banks and savings banks give a true and fair view of the financial position, operating results and cash flow in the preceding year. Auditors have responsibility for forming and expressing their independent opinion on balance sheet, profit and loss account and cash flow statement and the management of the respective bank or savings bank are responsible to keep the adequate accounting records.

Once a year a meeting is held with auditors as a forum to express opinion on audited banks and savings banks and auditors' reports, as well as to exchange views on related issues. In case a severe non-compliance or heavily impaired position of a

bank or savings bank has been identified, meetings with auditors may be organised more often. Contacts between the Bank Supervision Department and auditors regarding unresolved professional issues in day-to-day business are more frequent.

Efforts have been made within the framework of the Bank Supervision Department to develop further auditing profession, especially in co-operation with the Slovenian Institute of Auditors and the Internal Audit Board within the Bank Association of Slovenia. Pro-active role that the Bank Supervision Department plays in this field, has often resulted in taking part in finding solutions to problems arising in accounting, as well as in upgrading accounting standards through the Accountancy Board operating within the Bank Association of Slovenia.

2. RESULTS OF OPERATIONS OF BANKS AND SAVINGS BANKS IN THE YEAR 1997 AND THE FIRST HALF OF 1998[4]

2.1. Structure of the banking sector

At the end of 1997, just like at the end of June 1998, there were twenty-eight banks[5] in the Slovenian banking community and two more banks established pursuant to the Constitutional Law on the Implementation of the Charter on Independence and Sovereignty of the Republic of Slovenia (hereinafter: Constitutional Law). In addition, there were six savings banks, and seventy savings co-operatives. In comparison with the year 1996, the number of banks and savings banks was lower by only one bank and one savings bank. As at 1 January 1997, the merger between Banka Noricum d.d. Ljubljana and Banka Celje d.d., became effective, while in November 1997 the proceedings for the liquidation of savings bank Hranilnica in posojilnica d.o.o. Novo Mesto were instituted. The number of savings co-operatives was decreased only by one savings co-operative as in the year 1997 two savings co-operatives were wound-up, but one new was set up.

There are no branch offices of foreign banks operating in Slovenia. At the end of June 1998, there were eight representative offices of foreign banks in Slovenia.

In the year 1997 and in the first half of 1998, the market share of savings banks and savings co-operatives remained static and tiny in comparison with the market share of banks and notched only 2 per cent (at the end of 1996: 1.8 per cent).

Out of 28 operating banks, 13 banks are entirely owned by domestic shareholders (unchanged in comparison with the end of 1996 and end-1997). There are 4 banks either wholly-owned or controlled by foreign persons. Other 11 banks are controlled by domestic shareholders and most of them do not have even 1 per cent foreign-owned share each.

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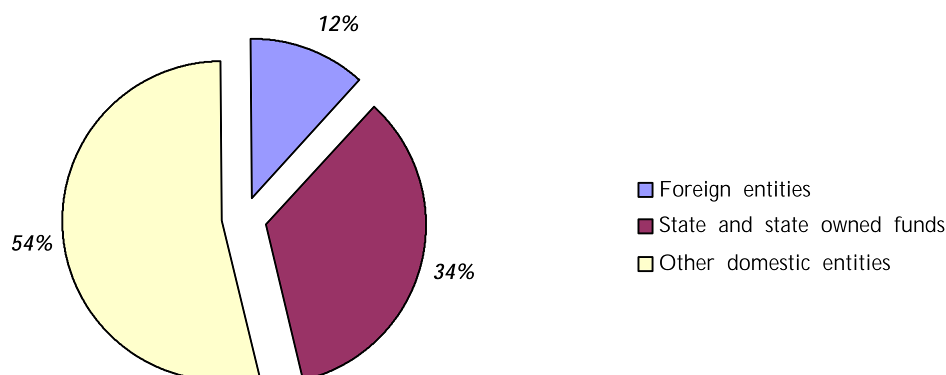
[4] Figures for the first half of 1998, i.e. for the period ended 30 June 1998 have not been audited.

[5] Prior to the publishing of the English version of the Report, the number of banks operating in Slovenia dropped to 25 following two mergers and one liquidation. Another merger is being negotiated.

Figure 1: *Ownership structure of the banking system as at 31 December 1997*



With the exception of two banks (Nova Ljubljanska banka and Nova Kreditna banka Maribor), whose market share was almost 40 per cent at the end of June 1998, and Po{tna banka Slovenije d.d., which is indirectly in state ownership, all banks are in private hands. Savings banks are wholly owned by domestic persons and are mostly in private ownership.

The market share of the top seven **banks** measured by unconsolidated total assets has been between 71 and 72 per cent since the end of 1994. Considerable differences are evident between seven leading banks in the amount of their total assets - at the end of June 1998 this figure was over SIT 590 billion in the largest one, while the bank ranked seventh had total assets amounting to only one sixth of total assets of the number one bank - approximately SIT 100 billion. In the smallest Slovenian bank, total assets stood at SIT 3 billion which is equal to total assets of the largest Slovenian savings bank. Albeit the bank concentration is not so high as following the independence of Slovenia, the aggregated market share of the ten smallest banks remains painfully low - mere 7 per cent.

Table 1: *Total assets and market share of seven largest banks (on the basis of unconsolidated total assets)*

in millions of tolars *in %*

Bank	Total assets			Market share		
	31 Dec 96	**31 Dec 97**	**30 Jun 98**	**31 Dec 96**	**31 Dec 97**	**30 Jun 98**
NLB *	490,299	549,225	594,350	28.4	27.2	27.2
SKB banka	206,584	241,010	258,191	11.9	11.9	11.8
NKBM	197,201	237,654	259,221	11.4	11.8	11.9
Banka Koper	99,251	120,299	132,922	5.7	5.9	6.1
Banka Celje	89,504	109,246	115,450	5.2	5.4	5.3
Abanka	88,348	103,055	113,540	5.1	5.1	5.2
Gorenjska banka	71,833	90,706	99,713	4.2	4.5	4.6
Total - top 7 banks	1,243,020	1,451,195	1,573,387	71.9	71.8	72.0
Total - all banks	1,729,083	2,022,037	2,186,667	100	100	100

* Figures including NLB branch in Milan.

Table 2: *Total assets and market share of banking groups (on the basis of unconsolidated total assets)*

in millions of tolars, in %

Banking groups	**Total assets 31 Dec 97**	**Market share 31 Dec 97**	**Total assets 30 Jun 98**	**Market share 30 Jun 98**
Banka Celje	120,727	6.0	127,071	5.8
NLB	705,281	34.9	760,262	34.8
SKB	253,521	12.5	269,250	12.3
Banka Koper	133,800	6.6	147,192	6.7

Differences in size between **savings banks** have remained considerable, even though their market share is practically negligible when compared with the entire banking sector - mere 0.3 per cent. A case in point is that total assets of the largest savings bank equalled SIT 2.9 billion at the end of June 1998 - almost as much as total assets of the smallest bank, total assets of the smallest savings bank failed short of SIT 500 million. The upper half of all savings banks has 70.9 per cent share in aggregate assets of savings banks.

Vigorous development of the banking sector is also reflected in comparisons with GDP. At the end of 1997, aggregate assets of the banking sector accounted for 70 per cent of gross domestic product (hereinafter: GDP).

Table 3: *Number of business units and headcount in the banking sector, total assets and GDP*

	31 Dec 92	31 Dec 93	31 Dec 94	31 Dec 95	31 Dec 96	31 Dec 97	30 Jun 98
Number of business units	555	559	538	558	577	590	
Number of employees	10,126	9,452	9,752	10,137	10,317	10,410	
Total assets (in millions of tolars)	627,886	937,203	1,183,423	1,497,544	1,729,083	2,022,037	2,186,667
Total assets/Number of employees (in millions of tolars)	62.0	99.2	121.4	147.7	167.6	194.2	
GDP at current prices (in millions of tolars)	1,017,965	1,435,095	1,852,997	2,221,459	2,552,668	2,906,687	3,279,910*
Total assets/GDP (in %)	61.7	65.3	63.9	67.4	67.7	69.6	66.5

* Estimate

2.2. Bank rehabilitation

In the year 1997, the rehabilitation of two banks, Nova Ljubljanska banka d.d. (hereinafter: NLB), Ljubljana, and Nova Kreditna banka Maribor d.d. (hereinafter: NKBM), placed under a formal rehabilitation programme in 1993 and thus turned into state property was successfully completed. Most bad loans were transferred to the Agency for the Rehabilitation of Banks and Savings Banks and swapped for government bonds. Since no other bad loans have been granted in the extent higher than common for any commercial bank after 1993, banks have considerably less dud assets than back in 1993. Capital adequacy has increased in both banks, liquidity has improved, and yield in both NLB and NKBM is among the highest in the Slovenian banking industry.

The requirements laid down by the Bank of Slovenia forced both banks to fulfil the criteria listed below prior to the completion of the rehabilitation process:

1. To be liquid,
2. To implement monetary policy measures,
3. To maintain regulatory capital in the amount necessary to sustain the current volume of banking operations executed under a full banking licence,
4. To adjust the volume of operations as to maintain regulatory capital at not less than 8 per cent of total assets and off-balance-sheet items on the assets side allotted and indexed according to the extent of risk associated with such operations,
5. To make adequate provisions with the aim to safeguard the bank against potential losses,
6. To abide by mandatory requirements that restrict maximum exposure to a single client,
7. To observe the ceiling imposed on investments in land, buildings, equipment, fittings and fixtures, and equity stakes in banks and non-bank organisations.

The decree on the termination of the rehabilitation process dated 6 June 1997 reads that the two banks have fulfilled the requirements listed above being the precondition for the completion of the retrenchment with the exception of the provision referring

to the ratio between regulatory capital and investments in property, premises, equipment, fixtures and fittings, and equity investments (Article 28 of the Law on Banks and Savings Banks). As NLB did not comply with the provisions of Article 28, it was to submit to the Bank of Slovenia within 30 days after passing the Decree a detailed plan showing steps eventually leading to full convergence with the provisions of the said Article, but not later than 31 December 1998. Pursuant to the Decree, both banks had to adopt articles of association and to appoint members of the supervisory and management board.

Following the adoption of the Articles of Association and the appointment of the members of both boards, the Bank of Slovenia issued the decree on the implementation of the decree on the completion of the rehabilitation in both banks on 22 July 1997. The completion of rehabilitation brought an end to the special status of the two banks and put them on the same footing with other commercial banks, meaning that both banks will have to address the issues of prudential banking as other banks do. The pending privatisation of the remaining state-owned property including the two banks is being handled by the government and the parliament of the Republic of Slovenia.

2.3. Total assets

Total assets of all Slovenian **banks** (often referred to as balance sheet total) added up as at 31 December 1997 to SIT 2,022.0 billion according to the audited data - a nominal growth of 16.9 per cent with respect to the end of December 1996, when total assets grew by one percentage point (15.5 per cent in nominal terms) compared with the end of 1995. In real[6] terms, totals assets of all major Slovenian banks increased by 6.9 per cent in 1997, as opposed to 1996 when the growth rate notched 6.2 per cent.

For 1998, a growth rate in the range of the value recorded in 1997 can be expected, as the nominal growth during the first and second quarter of 1998 with respect to December 1997 was 8.1 per cent[7], total assets of all twenty-eight operating banks equalled SIT 2,186.7 billion[8].

As at 30 June 1998, four banks reported decrease in total assets in nominal terms resulting in figures inferior to those recorded in December 1997, while in as many as eight banks (at the end of 1997 this happened in four banks), total assets declined in real terms.

As to total assets in **savings banks**, assets recorded at the end of 1997 totalled SIT 7.2 billion, which means nominal growth by 42.6 per cent, i.e. real growth of 30.3 per cent with respect to the year 1996, and reflects faster growth than in the year 1996 when real growth was a modest 5.7 per cent.

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[6] By taking into account retail price index in 1997 and 1996 of 9.4% and 8.8%, respectively, the exchange rate growth for D-mark was 3.74% and 3.53% in 1997 and 1996, respectively.
[7] If consumer price index of 4.9% for the first half of 1998 is used, then the real growth rate is 3.1% or the real decrease rate by taking into acount that the exchange rate for D-mark was by 0.7% lower at end-June 1998 than at the end of 1997.
[8] Including NLB branch in Milan.

A year-on-year comparison shows that at end-1997 with respect to end-1996, total assets increased in all savings banks, and the positive trend continued also until the end of the period under review when as at end-June 1998, assets in savings banks totalled SIT 8.9 billion, i.e. showed almost 17% real growth (22.7 per cent nominal growth) with respect to end-December 1997.

2.4. Liabilities and assets of banks and savings banks

2.4.1. Liabilities and assets of banks

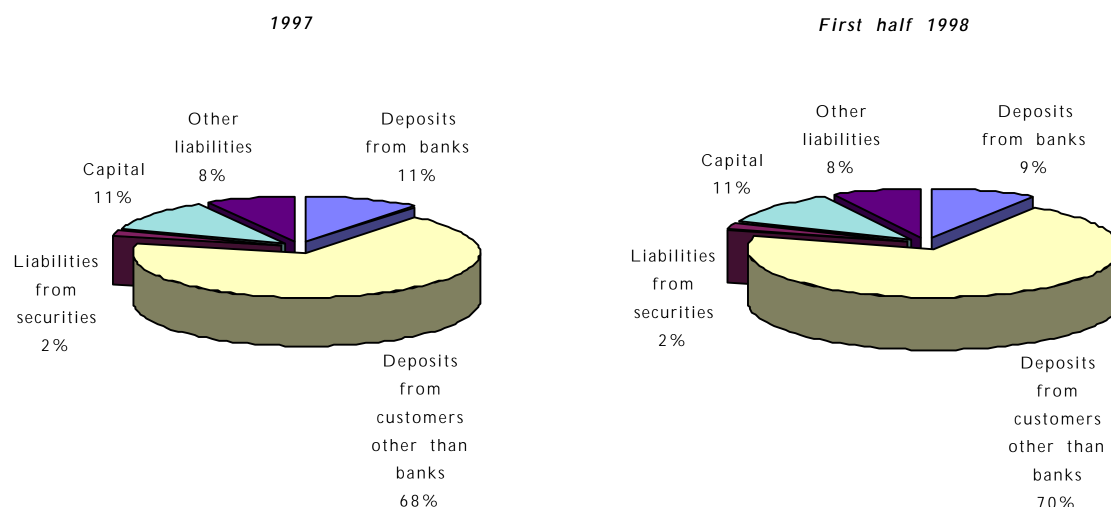
2.4.1.1. Liabilities of banks

A comparison between average structure of **banks'** liabilities in the first half of 1998 and in the year 1997 with respect to the year 1996, shows that trends which hallmarked previous years have persisted. In other words, the share of liabilities to the banking sector has been decreasing (from 14.3 per cent in the year 1996 to 9.3 per cent in the first half of 1998), whilst the share of liabilities to non-banking sector has been increasing (from 63.3 per cent to 69.5 per cent in the same period). Liabilities to private individuals have been growing rather strongly (from 34.2 per cent to 37.8 per cent of total liabilities). At the same time, liabilities to corporate sector have not recorded substantial changes by rising from 16.3 per cent to 16.6 per cent of total liabilities).

The share of banks' liabilities for issued securities since 1996 until the first half of 1998 has been in the range of 2 per cent, the share of stockholders equity has remained in the range of 11 per cent, and other liabilities[9] have been in the bracket between 8 and 9 per cent.

[9] Other liabilities comprise accruals and deferred income, general and specific provisions and other liabilities.

Figure 2: *Average structure of banks' liabilities*



Liabilities to customers other than banks remain the main source of banks' funds and deposits from private customers prevail. In the first half of 1998, non-banking customers' deposits accounted for 54.1 per cent (1997: 53.5 per cent) of the average composition of liabilities to non-banks. During the same period, corporate deposits accounted for 25.8 per cent (1997: 24.5 per cent) of all deposits from non-banks, deposits from public sector increased to 8.5 per cent (1997: 7.4 per cent), and government deposits dropped to 4.2 per cent share of liabilities to non-banks (1997: 5.3 per cent).

In the composition of liabilities to non-banking sector (as at 31 December 1997: SIT 1,412.2 billion), all banks recorded in the year 1997 the most vigorous growth of retail deposits (21.3 per cent at end-1997 with respect to end-1996, 11.5 per cent at end-June 1998 with respect to end-1997), mainly due to an increase in short-term deposits from private individuals denominated in tolars. At the same time, the growth in retail demand deposits slowed down, and long-term corporate deposits in foreign currency shrank. The strongest growth was recorded in deposits repayable between one and three months, hence short-term retail deposits gained a fatter slice in the structure of retail deposits, while demand and long-term deposits decreased. Six out of seven banks heading the list of biggest banks in Slovenia have reported retail deposit growth below average.

The composition of retail deposits shows that the share of savings in domestic currency is rising, as in the first half of 1998 it already exceeded a half of all retail deposits (from 41.4 per cent at the end of 1996 to 53.8 per cent at the end of June 1998) at the expense of savings in foreign currency (from 58.6 per cent to 46.2 per cent). Retail deposits denominated in foreign currency at end-1997 and end-June 1998 accounted for more than a half of liabilities in foreign currency of all banks (53.8 per cent and 56.0 per cent, respectively). A few smaller banks have on their books a fatter share of retail deposits in foreign currency (over 80 per cent).

Corporate deposits were lagging behind retail deposits during the period under review as a year-on-year comparison shows growth rate of 16.9 per cent (end-1997/end-1996), plunging to mere 2.6 per cent (end-June 1998/end-1997).

Liabilities to banking sector totalling SIT 204.1 billion as at 31 December 1997, dropped at the end of June 1998 in comparison with the end of 1997 by 0.8 per cent, while the decrease as at 31 December 1997 as opposed to 31 December 1996 was 4.6 per cent. The decrease is mainly due to the lower volume of borrowing from the Bank of Slovenia and domestic banks, thus reflecting improved liquidity across the banking system.

The share of average foreign exchange liabilities in average liabilities was steadily decreasing from the end of 1996 to the end of June 1998: from 38.8 per cent at end-1996 to 32.5 per cent at end-June 1998. The decrease in foreign exchange deposits from other banks was sharp, and short-term time deposits of banks in foreign currency dropped more than other kinds of deposits.

The share of average short-term liabilities in average liabilities was also gradually increasing during the period under review (end-1996 until end-June 1998), rising from 66.9 per cent at the end of 1996 to 68.6 per cent after first and second quarter of 1998. The increase in the short-term balance sheet items may be attributed to heftier balances in giro accounts of corporate sector, sole traders, financial institutions, citizens' current accounts, and rising short-term retail deposits.

2.4.1.2. Assets of banks

The composition of average banks' assets reveals a trend already highlighted on banks' liabilities side - loans and advances to the banking sector dropped from 17.7 per cent at the end of 1996 to 9.6 per cent at the end of June 1998, while non-banks loans and advances stayed in the region of 41 and 43 per cent. Considerable increase can be noticed in investments in securities, hence securities grew from 26.2 per cent at the end of 1996 to 34.4 per cent at the end of June 1998. The share of cash in hand and balances in accounts held with central bank has been in the range of 3 per cent over the past year and a half, while the share of other assets[10] remained between 10 and 11 per cent.

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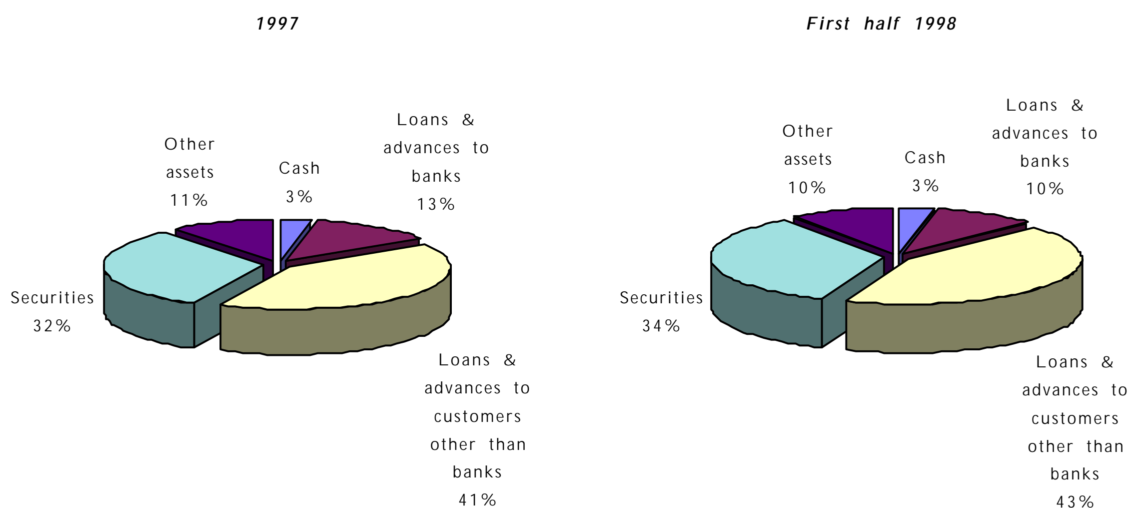
[10] Other assets comprise investments in subsidiaries and affiliated undertakings, tangible fixed assets, intangible ssets, subscribed and unpaid capital and own shares bought back, prepayments and accrued income, and other assets such as cheques, receivables for interest, fees and commissions, etc.

Figure 3: *Average composition of banks' assets*



Banks on average placed the bulk of their assets in non-bank loans and advances which went mostly to corporate customers as opposed to banks' liabilities side. In the first half of 1998, the average structure of banks' assets consisted of 62.3 per cent of loans and advances granted to customers other than banks (1997: 62.8 per cent), retail lending standing at 27.5 per cent (1997: 28.2 per cent), loans and advances to public sector standing at 5.5 per cent (1997: 5.8 per cent), and loans and advances to government standing at 1.7 per cent of all non-bank loans and advances (1997: 0.8 per cent).

Out of non-bank loans and advances (totalling SIT 862.4 billion at year-end 1997), just like on the banks' liabilities side, loans and advances to private individuals were growing at a faster rate than corporate lending. The growth rate of retail lending at the end of 1997 with regard to the end of 1996 was 15.8 per cent. The growth rate decreased to 12.6 per cent at the end of June 1998 with regard to the end of 1997, while the growth of corporate lending at the end of 1997 with regard to the end of 1996 was 12.9 per cent, and 11.3 per cent at the end of June 1998 compared with the year-end 1997.

A case in point is that over the past years, the growth in retail lending has become more moderate as only a couple of years ago, more precisely in 1996, the retail lending growth rate was as high as 29.4 per cent.

Loans and advances to banking sector totalling SIT 214.9 billion as at 31 December 1997, dropped by 10.8 per cent as at the end of June 1998 in comparison with the end of 1997, while figures reported as at 31 December 1997 were lower by 30.7 per cent with respect to figures as at 31 December 1996. Over the past year and a half, the hallmark has been the transformation of time foreign exchange investments into securities, predominately into securities issued by the Bank of Slovenia.

During the period under review, banks were investing ever increasing amounts in securities, generally those with short-term maturity. The composition of securities portfolio reveals investment securities to be in majority, and bills issued by the central bank account for the bulk of investment securities, followed by rehabilitation bonds, bonds issued for paid out and unpaid foreign exchange savings deposits, rehabilitation bonds of the Slovenian Steel Works, as well as other bonds issued by the Republic of Slovenia. The share of investment securities in the average assets structure increased from the end of 1996 when it accounted for 24.6 per cent to 30.3 per cent at the end of June 1998. In absolute terms, investment securities rose from SIT 449.2 billion to SIT 643.5 billion as the result of the increased underwriting of the Bank of Slovenia bills. Another reason for accelerated investing in securities can be found in the requirements forcing banks to make additional liquidity reserves, to adjust maturity structure of liabilities and assets, and the resolution of the problem of foreign exchange mismatch (closing open foreign currency position in most banks)[11].

The portion of securities held for dealing purposes accounting for 1.6 per cent of assets at the end of 1996 grew to 4.1 per cent at the end of June 1998, but is still regarded as meager. In absolute terms, investments in dealing securities increased from SIT 29.4 billion to 92.7 billion as at end-June 1998.

A half of banks' portfolio are securities issued by the Bank of Slovenia, followed by securities issued by the Republic of Slovenia, and a tiny portion composed of securities issued by public sector and other issuers. The above data reflect sound secondary liquidity reserves in commercial banks.

In March 1997, the Republic of Slovenia issued a series of bonds designated as RS04[12]. In the second half of the year 1997, the Ministry of Finance invited bondholders to swap their bonds for the new bond issue[13]. Out of the total number of twelve banks - holders of bonds for obligations assumed for unpaid foreign exchange deposits, nine banks accepted the offer to swap old bonds for the so-called TOM bonds (TOM is Slovene abbreviation for base interest rate).

The average share of foreign exchange assets of all banks in aggregate assets declined from the end of 1996 when it accounted for 34.1 per cent to 31.0 per cent at the end of June 1998, mainly due to the decrease in time deposits placed abroad with short maturity, and the decline in time deposits with short maturity placed with domestic banks, both kinds of deposits are denominated in foreign currency.

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[11] The decree issued by the Bank of Slovenia on foreign exchange minimum has resulted in rising the mandatory percentage of banks' investments in the bills issued by the Bank of Slovenia prescribed to meet foreign exchange minimum requirement from 40% to 50% by 30 May 1997, further rising to 60% of aggregate foreign exchange minimum by 31 August 1997.

[12] Pursuant to the Law on Settlement of Liabilities for Unpaid Foreign Exchange Deposits, the Republic of Slovenia has undertaken in the year 1993 to assume from banks their claims arising from unpaid foreign exchange retail savings deposits held in banks in Slovenia and deposited with the National Bank of Yugoslavia. Bonds designated as RS04 were issued in the total nominal amount of DM 841 million as a dematerialised security, maturing in June 2022, interest rate D (exchange rate)+8%, annual and semi-annual payment of interest. Bonds were registered in the name of the holder and were negotiable without restrictions.

[13] New bonds differred from the old ones by interest rate (D+4%, TOM+4,5%), shorter maturity period (2007), payment of interest (annual), and replacement option (DEM/TOM bonds).

The average share of short-term assets has been increasing with respect to total assets rising from 57.1 per cent at the end of 1996 to 60.5 per cent at the end of June 1998. The increase in the share of assets with short maturity is to be attributed to the rise in underwriting bills issued by the Bank of Slovenia.

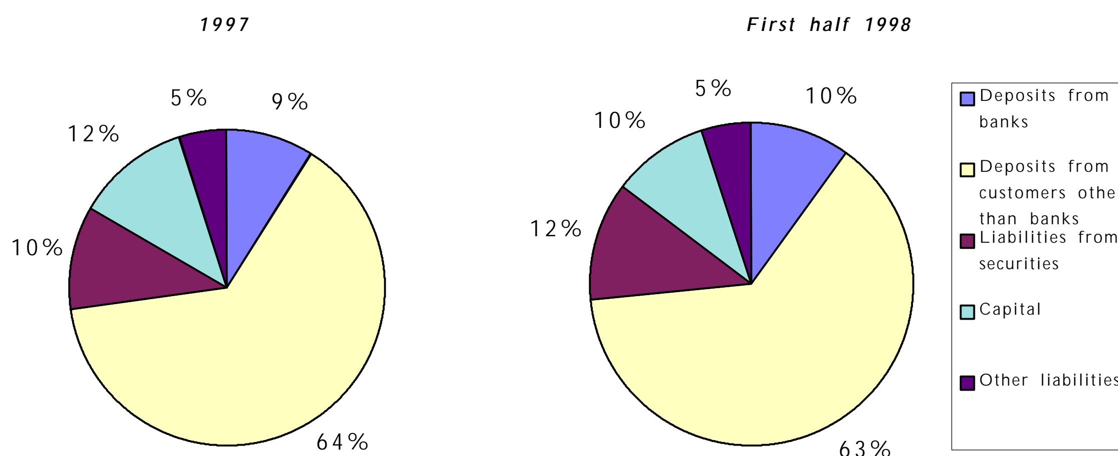
2.4.2. Liabilities and assets of savings banks

2.4.2.1. Liabilities of savings banks

The main source of funds and the generator of growth in **savings banks** in the period under review were non-bank deposits standing at SIT 4,643 million as at 31 December 1997. The share of non-bank deposits in average total liabilities was somewhat lower than in banks remaining over the past year and a half in the range of 64 per cent.

Among aggregated deposits of all savings banks retail deposits prevail and as at end-June 1998, these deposits accounted for 26.7 per cent of the average sector structure of non-banking sector, although their share has been decreasing since 1996. As the share of corporate deposits grew over the first two quarters of 1998 to 26.0 per cent from 25.8 per cent at the end of 1997, corporate deposits practically caught up with retail deposits.

Figure 4: *Average composition of liabilities in savings banks*



2.4.2.2. Assets of savings banks

Loans and advances granted to customers other than banks totalling SIT 5,182.8 million as at 31 December 1997, accounted also in savings banks for the biggest share in average assets structure. The portion of this type of lending in savings banks on average is significantly higher than in banks, although it is gradually decreasing. At the end of 1996, lending to non-bank clients notched 76.9 per cent, while at the end of June 1998, it stood at 71.9 per cent. In comparison with the share reported at the end of 1997, non-bank loans and advances declined by 1.6 percentage points.

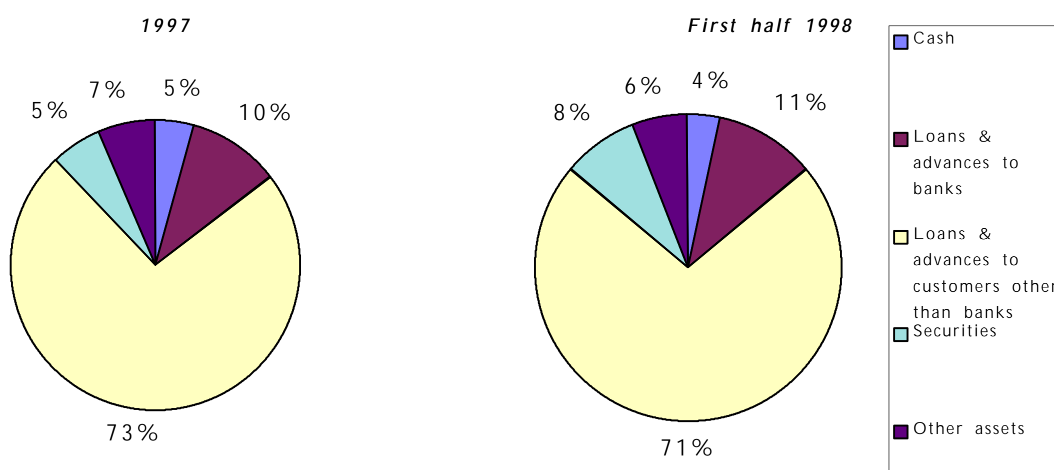
The composition of non-bank loans and advances reflects the decline in the share of loans and advances granted to corporate clients (a drop from 34.0 per cent at the end of 1996 to 20.2 per cent at the end of June 1998), mainly at the expense of the increase in loans and advances granted to private individuals (from 64.7 per cent to 78.1 per cent during the same period).

Savings banks' assets also show considerable differences during the period under review.

While savings banks had a modest share of securities of only 0.9 per cent at year-end 1996, in the course of 1997, securities gradually increased and at year-end 1997 constituted 5.4 per cent and at end-June 1998 represented already 7.9 per cent of average assets of savings banks. In the year 1997, savings banks were mostly underwriting tolar-denominated bills issued by the Bank of Slovenia.

At the end of 1997, a significant change occurred as the share of long-term assets of all savings banks increased from 29.5 per cent at end-1996 to 44.7 per cent in the first half of 1998, mostly due to a growth in long-term loans and advances granted to private persons.

Figure 5: *Average composition of assets in savings banks*



2.5. Profit and loss account of banks and savings banks

2.5.1. Profit and loss account of banks

In the year 1997, **banks** have earned SIT 21.1 billion in profit before taxes, whereas the revaluation gain amounted to SIT 19.3 billion or 91.4 per cent of the total profit before taxes. Profit before tax was by 15.0 per cent higher in nominal terms in 1997 with respect to the prior-year comparative. In the first half of 1998, profit before tax amounted to SIT 14.2 billion, whereas the revaluation gain stood at SIT 12.0 billion, i.e. 84.3 per cent of the aggregate profit before tax. With regard to the first half of 1997 when earnings of all banks totalled SIT 13.2 billion, profit grew in nominal terms by 7.7 per cent[14].

While at the end of 1996 only two banks reported losses, at the end of 1997 this number doubled to be halved eventually after the first six months of 1998 when two banks showed losses.

Operating results the banks delivered in the year 1997, as opposed to 1996, are affected by lower real income arising from interest rate which is due to more balanced lending growth, but is also the result of heftier investments in securities. The influence of gradual lowering of interest rates in the banking industry, real growth of income generated by fees and commissions (from payment transactions, agency activities, commission for administrative services), and the growth of profit generated by financial operations, has also to be recognised.

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[14] Consumer price index for the first half of 1998 was 4.9 per cent, i.e. 2.7 per cent real growth.

Table 4: Composition of income and expenses of banks

	Year 1996 (in millions of tolars)	Year 1997 (in millions of tolars)	1H98 (in millions of tolars)	Nom. growth 1997/1996 (in %)	Nom. growth 1H98/1H97 (in %)
Net interest income	81,041	84,325	46,789	4.1	22.2
-real part	50,826	54,936	28,093	8.1	5.7
-revaluation part	30,215	29,388	18,696	-2.7	59.5
Net fees and commissions	23,627	26,923	14,387	14.0	12.6
Income from securities	1,771	1,359	838	-23.3	212.4
Net financial operations	-2,657	6,104	3,685		-25.3
General administrative expenses	50,293	58,111	30,462	15.5	15.3
Depreciation/amortisation	5,821	7,393	4,426	27.0	39.3
Operating profit	47,668	53,206	30,811	11.6	15.5
Net amounts written off	9,058	16,615	20	83.4	-99.2
Net provisions	14,431	5,625	9,004	-61.0	65.2
Net other	812	1,168	762	43.7	-243.8
Revaluation of capital, fixed assets and capital investments	8,465	10,665	7,052	26.0	9.9
Gain (loss) from ordinary activities	16,526	21,469	13,972	29.9	7.9
Gain (loss) from extraordinary activities	1,815	-382	229	-121.0	-2.9
Profit on ordinary activities before tax	18,341	21,087	14,201	15.0	7.7

In the year 1997, the banks earned SIT 84.3 billion in net interest - a nominal increase of 4.1 per cent with respect to the same period in 1996; in real terms, the banks earned 4.8 per cent less. The share of interest income in total earnings has been in the region of 80 per cent (1996: 80.4 per cent, 1997: 80.5 per cent, first half of 1998: 80.0 per cent).

Unlike interest income, the banks have reported real growth in fees and commissions receivable. This source of income rose in nominal terms by 14.0 per cent in the year 1997 with respect to 1996. In real terms, the increase for the period under review was 4.2 per cent, mostly on account of fees and commissions earned on cross-border payment transactions, and fees and commissions for administrative services rendered. The share of fees and commissions in total income has been steadily increasing (from 8.7 per cent in 1996 to 9.7 per cent in the first half of 1998).

Year-on-year comparison shows that in 1997 the realised growth in positive effect of net financial operations (profit reduced by loss made in financial operations) amounting to SIT 8.8 billion, was mainly the result of tighter regulations calling for more frequent valuation of securities introduced in 1996. Mandatory monthly portfolio valuation that takes into account securities at market or purchase value - whichever is lower - has borne beneficial results.

The banks allocated SIT 5.6 billion to net provisions[15] in the year 1997, or SIT 8.8 billion less than at the end of 1996. Shrunk aggregate provisions are attributed in the first place to the reduced provisions in two banks. In the year 1997, the banks recorded net write-offs[16] in the amount of SIT 16.6 billion, which means SIT 7.6 billion more than in 1996. Particularly high written-off amounts are reported by three banks. Sharp increase in net provisions and net write-offs is noticeable in some banks - members of banking groups - as the consequence of tighter portfolio valuation standards adhered to by the leading bank in the group. The shift of income provisions from net provisions to net write-offs is partly the result of different taxation treatment of these two items.

If on top of the gross profit realised in the year 1997 amounting to SIT 21.1 billion (in 1996 this amount stood at SIT 18.3 billion), also net provisions totalling SIT 5.6 billion (in 1996: SIT 14.4 billion) and net written-off amounts amounting to SIT 16.6 billion (in 1996: SIT 9.1 billion) are added, then the banks accumulated SIT 43.3 billion (in 1996: SIT 41.8 billion), or 11.8 per cent of aggregate income[17] earned by banks (in 1996: 12.6 per cent of aggregate income earned by banks).

As a percentage of total expenditure, interest payable accounts for the biggest share in costs rising in the year 1997 from 59.3 per cent recorded in 1996 to 60.9 per cent, and again decreasing down to 58.3 per cent in the first half of 1998.

The structure of expenditure shows that general administrative expenses are the second largest item after interest expense. The share of general administrative expenses has been increasing since 1996 when it constituted 16.0 per cent to 18.6 per cent in the first half of 1998. General administrative expenses grew in real terms in 1997 by 5.6 per cent in comparison with the year 1996. Higher staff costs accounted for the increase, but other service costs such as outsourcing and advertising also contributed to inflating this item in the period under review.

Revaluation balance (the difference between revaluation income and revaluation expense) accounted for in the year 1997 as opposed to 1996, plunged both in nominal and real terms from SIT 22.1 billion in the year 1996, revaluation balance shed 12.9 per cent and landed on SIT 19.3 billion at the end of 1997. The decreased balance of revaluation interest charged on loans/deposits in tolars and securities, as well as real increase of expenditure due to loss from foreign exchange differences may be blamed for the decrease. Revaluation expenditure also comprises the item called "capital revaluation adjustment" revalued in accordance with the increase of retail prices (1997: 9.4 per cent), being higher than the base interest rate (1997: 8.8 per cent), commonly used for loans and other investment revaluation.

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[15] Net provisions are composed of value adjustments, expenses for making provisions, income from released provisions, and income from released provisions.

[16] Net write-offs: write-offs of uncollectable debts - income arising from debts previously written-off.

[17] Banks' earnings in 1996 and 1997 amounted to SIT 333 billion and SIT 365 billion, respectively.

2.5.2. Profit and loss account of savings banks

Operating activities of **savings banks** resulted in profit before tax amounting to SIT 68 million in the year 1997, whereas revaluation gain equalled SIT 7.8 million. In the first half of 1998, profit before tax exceeded aggregate profit for the entire 1997: SIT 80.6 million (revaluation gain amounted to SIT 18.9 million or only 23.5 per cent of aggregate profit).

With respect to the prior-year, profit for 1997 increased by 28.4 per cent in real terms. Profit made in the first half of 1998 as opposed to the first half of 1997 was stronger in real terms.

Table 5: *Composition of income and expenses of savings banks*

	in millions of tolars				in %
	Year 1996	Year 1997	1H98	Nom. growth 1997/1996	Nom. growth 1H98/1H97
Net interest income	356	359	225	0.9	20.4
-real part	281	303	177	8.2	11.1
-revaluation part	75	56	48	-26.0	73.4
Net fees and commissions	126	183	119	45.5	34.2
Income from securities	1.3	0.7	0	80.5	
Net financial operations	16	26	19	68.3	51.7
General administrative expenses	289	317	185	9.7	19.2
Depreciation/amortisation	33	44	31	35.3	46.6
Operating profit	176	208	146	18.3	31.6
Net amounts written off	0	8	6		
Net provisions	95	82	34	-13.0	28.8
Net other	5	5	8	2.3	88.8
Revaluation of capital, fixed assets and capital investments	42	50	30	19.3	-13.0
Gain (loss) from ordinary activities	35	63	80	79.3	74.5
Gain (loss) from extraordinary activities	13	4	1	-66.2	-78.2
Profit on ordinary activities before tax	48	68	81	40.5	59.2

In 1997, savings banks generated SIT 359 million in net interest income. In nominal terms this income was at the level of the year 1996; in real terms, savings banks earned 7.8 per cent less on interest receivable. Lower interest income is primarily the result of higher revaluation expenditure. More precisely, it was due to revaluation expenses for deposits.

As already mentioned when talking about banks, savings banks recorded heftier income arising from fees and commission - in real terms this income surged by 33.0 per cent.

Fees charged on lending activities increased thus pushing up the figures. Savings banks recorded earnings arising from net financial operations higher in real terms, but the share of this kind of income is relatively modest in comparison with other sources of income.

Net provisions made in the year 1997 by savings banks totalled SIT 82.4 million, or by 13 per cent less than in 1996.

In 1997, all savings banks were in the black, while in the first half of 1998, one slipped into red figures. Aggregate revaluation gain generated by all savings banks in the year 1997 was substantially lower than in 1996 when it equalled SIT 34.7 million and accounted for a hefty 72.2 per cent chunk of aggregate pre-tax profit. In the year 1997, revaluation gain constituted only 11.6 per cent of entire profit. A reason for deflated revaluation gain is, in addition to lower revaluation gain made on loans/deposits, the increase of revaluation expenses incurred on securities, and capital revaluation expenses.

2.6. Profitability ratios

Table 6: *Profitability ratios for banks*

in %

	31 Dec 96	*31 Dec 97*	*30 Jun 98*
Return on average assets	1.1	1.1	1.4
Return on average equity	10.2	10.3	12.9
Net interest margin*	5.6	4.9	5.0
Labour cost/Average assets	1.9	1.9	1.8
Other operating expenses/Average assets	1.7	1.8	1.9

* Net interest margin is calculated as the ratio between total interest (real and revaluation interest) and average gross interest-bearing assets.

Sound operating results boosted return on average assets and return on average equity in **banks** in the period under review, i.e. the last 18 months.

Operating expenses, on the other hand, comprising labour costs and other operating costs, remained at the same level in the period under review, thus amounting to 3.7 per cent of average assets for 1997 and the first half of 1998.

Net interest margin[18] that grew steadily from 3.7 per cent in 1994 to 5.6 per cent in 1996, reversed in the year 1997 and kept on getting thinner also in the first half of 1998. Net spread earned by banks still varies from one bank to another, hence at the end of 1997, it was in the range from 2.1 per cent to 9.1 per cent.

[18] Interest-bearing assets as at 31 December 1997 amounted to SIT 1,791.5 billion or 88.6 per cent of total assets of all banks.

Movements in interest rate in the course of 1997 (having taken into account inflation and bank costs) were strongly influenced by the changed methodology, i.e. by base interest rates and interbank agreement on interest rates.

In April 1997, the Governing Board of the Bank of Slovenia extended the base for the calculation of average indexation factor from six to twelve months, thus making the nominal interest rate even less sensitive to monthly inflation fluctuations and more dependent on the real interest rate component.

A new interbank agreement on capping interest rate on deposits came into effect as of 1 April 1997. The new ceiling endorsed further lowering of interest rates on deposits. Consequently, the banks reduced lending interest rates as well. The first wave of cutting real interest rates came in April 1997. The average real interest rate on short-term deposits (31 to 90 days) illustrates the scale of the effect the cartel agreement had on banking industry as it dropped from 4.9 per cent in May 1996, to 3.7 per cent in April 1997. This rate prevailed until the end of February 1998, but from 1 March 1998 when the latest cartel agreement on deposit interest rate ceiling became effective, rates continued to slide. As the new agreement meant further interest-rate cuts, in March 1998, the average interest rate on deposits between 31 and 90 days was 2.3 per cent. Since the March 1998 agreement was further amended, the average deposit interest rate was cut down to 0.9 per cent in July 1998.

On the assets side, average interest rates followed suit sliding downward both on short-term and long-term loans. Average real interest rate on short-term loans granted to corporate sector decreased gradually from 11.3 per cent in January 1997 to 9.6 per cent in December 1997. Steady downward trend persisted through the first half of 1998 and at the end of June 1998, the benchmark was 6.9 per cent. Long-term loans granted to companies for the purchase of fixed assets cost corporate borrowers 12.4 per cent in January 1997, while in December 1997 the average interest rate was 10.7 cent. At the end of June 1998, the average interest rate was 8.1 per cent.

Interest rate spread[19] as the difference between the average nominal interest rate receivable and the average nominal interest rate payable on assets/investments from customers other than banks fell from 8.3 per cent in the first quarter of 1997 to 7.0 percentage points in the second quarter of 1998. Interest spread in the real interest rate component arising from banking business with non-bank customers shrank from 5.5 percentage points to 4.1 percentage points over the same period.

Yield on average assets and yield on average equity have been rising also in **savings banks**. While the return on average assets was 1.0 per cent in 1996, it was 2.0 per cent in the first half of 1998 showing better performance than bank had. The return on average equity soared from 7.5 per cent in the year 1996, to 20.8 per cent in the first half of 1998, showing once more that savings banks outperformed banks in the period under review.

The Slovenian savings banks have followed the same policy of cutting interest rates and it has resulted in thinner net interest rate spread. In the first half of 1998, the realised 5.8 per cent was still higher figure than recorded in banks. If compared with 8.0 per cent in the year 1996, the reduction in the net interest rate spread achieved

[19] Difference between interest on deposits and interest on loans.

in savings banks significantly surpasses the results achieved in banks over a year-and-a-half period.

The Slovenian savings banks have been more efficient also in cutting labour costs and other operating costs. In the period from end-December 1996 to end-June 1998, these costs were lower, although still exceeding costs reported by banks. In the first half of 1998, general administrative costs amounted to 5.6 per cent of average assets (in 1996: 6.9 per cent of average assets).

2.7. Credit risk

Credit risk[20] assessment made by banks takes into account criteria laid down in the Decree on the Classification of On- and Off-Balance Sheet Items of Banks and Savings Banks (Official Gazette of the Republic of Slovenia, Nos. 78/96, 49/98). The criteria implemented when ranking debts in five categories ranging from A (standard) to E (bad) have been tightening since the year 1992 when the alarm went off only in case of default. In 1993, more demanding requirements were endorsed and remained in force until the end of 1996. As of 1 January 1997, stern criteria designed to improve financial rectitude, were put in place. Even though the methodology effective from 1993 until 1996 was based on the assessment of the creditworthiness of the borrower, it was still allowed to secure the loan by pledging movable property and real estate as a collateral and rank the loan as A, i.e. place it in the best category, starting with January 1997, a loan secured by pledging property may be graded only in one category higher than the ranking assigned to that loan on the basis of the customer's creditworthiness would be. Phasing in tighter criteria alleviated immediate deterioration of banks' credit portfolios and the time left for earmarking additional funds to make adequate provisions in line with the stringent criteria, was stretched until the end of 1997.

Despite gloomy expectations, **banks**' credit portfolios at the end of 1997 were not affected in comparison with the end of 1996. A number of banks acted timely and started to classify loans granted to customers exclusively on the basis of the assessment of the borrower's creditworthiness, even before the Decree became effective. While there are still different kinds of collaterals found, the share of securities issued by the Bank of Slovenia has grown (A category).

Performing assets in banks (on- and off-balance sheet items classified in the best and the second best category, A and B, respectively), accounted for 94.5 per cent at the end of 1997, or 0.8 percentage points more than at the end of 1996. The share of bad and doubtful assets (receivables classified in categories D and E) decreased from 3.8 per cent at the end of 1996 to 3.2 per cent at the end of 1997. Performing assets grew further to a new high at the end of June 1998.

[20] Credit risk is defined as the risk that a borrower will not repay to the bank all his debt or only a portion on maturity.

Table 7: *Classification of on- and off-balance sheet items in banks*

in %

Category	*31 Dec 93*	*31 Dec 94*	*31 Dec 95*	*31 Dec 96*	*31 Dec 97*	*30 Jun 98*
A	81.1	86.1	89.4	89.5	90.1	90.0
B	6.6	5.7	4.8	4.2	4.4	4.8
C	4.7	2.5	1.9	2.4	2.3	1.9
D	3.2	2.6	2.1	2.2	1.8	1.8
E	4.3	3.1	1.8	1.6	1.4	1.5

Aggregate exposure of banks to credit risk was SIT 2,294.0 billion as at 31 December 1997 (this amount is composed of SIT 1,911.3 billion in risk-weighted on-balance sheet items, and SIT 382.6 billion in risk-weighted off-balance sheet items). With respect to the year 1996, the aggregate exposure has been increased by 15.6 per cent. The exposure to blue-chip customers ranked as A borrowers grew by 16.4 per cent and is the result of an upswing in subscribing short-term securities issued by the Bank of Slovenia. On the other hand, it is partly due to write-offs at the end of 1997 amounting to SIT 16.6 billion (in 1996: SIT 9.1 billion). Hence the share of non-performing assets has been reduced. Funds set aside for adjustments and provisions grew by 3.9 per cent in comparison with the year 1996, thus providing safety net in excess of mandatory adjustments and provisions.
As at 30 June 1998, the aggregate exposure of banks to credit risk grew by 7.9 per cent with respect to 31 December 1997, totalling SIT 2,457.3 billion. The most obvious rise was recorded in loans in the B category, while loans graded as the C category shrank in comparison with the end of 1997.

Table 7a: *Exposure of banks per category and per adjustment and provision made*

in millions of tolars

Category	*Aggregate exposure* ***31 Dec 1996***	*Adjustments, provisions* ***31 Dec 1996***	*Aggregate exposure* ***31 Dec 1997***	*Adjustments, provisions* ***31 Dec 1997***	*Aggregate exposure* ***30 June 1998***	*Adjustments, provisions* ***30 June 1998***
A	1,776,331	158	2,067,463	1,325	2,228,727	250
B	83,785	9,898	100,241	11,772	118,001	13,974
C	47,365	14,926	53,040	17,386	47,591	14,947
D	44,544	30,313	40,352	27,925	44,094	31,126
E	32,558	32,592	32,885	32,877	36,869	36,754
TOTAL	1,984,583	87,887	2,293,981	91,285	2,475,282	97,051

If receivables due from the Republic of Slovenia and the Bank of Slovenia were subtracted from A-graded receivables, the share of first-class assets would be reduced while the share of other assets would increase. As at 31 December 1997, the share of A-graded receivables, excluding the above-mentioned receivables, was by 4.4 percentage points lower, thus standing at 85.7 per cent. The share of B-graded receivables was by 1.9 percentage points higher (standing at 6.3 per cent), while the share of non-performing assets (receivables classified in the categories C, D and E), increased by

1.7 percentage points and reached 7.9 per cent.

Likewise, the share of A-graded receivables as at 30 June 1998 decreased by 4.8 percentage points and stood at 85.2 per cent. The share of B-graded receivables rose to 7.1 per cent (rising by 2.3 percentage points), while the share of other assets grew from 5.2 to 7.7 per cent.

Should the creditworthiness of corporate customers be assessed without taking into consideration the quality of security, the share of receivables classified as at 31 December 1997 in the A category would decrease from 90.1 to 84.8 per cent. Consequently, the share of receivables classified in other categories would rise. The B category would accommodate 7.4 per cent of all receivables, whereas the share of non-performing assets would grow from 5.5 per cent to 7.8 per cent.

Following the same pattern, the share of A-graded receivables fell from 90.0 per cent to 84.3 per cent at the end-June 1998, while the share of B-graded receivables rose by 3.8 percentage points to 8.6 per cent. The share of receivables graded C, D and E, also increased by 1.9 percentage points to 7.1 per cent.

Table 7b: *Classification of banks' depositors regardless of the type of security*

in %

Category	*31 Dec 1995*	*31 Dec 1996*	*31 Dec 1997*	*30 Jun 1998*
A	83.4	83.5	84.8	84.3
B	8.0	7.7	7.4	8.6
C	3.4	3.7	3.2	2.6
D	2.9	2.7	2.4	2.3
E	2.3	2.5	2.2	2.2

The share of bad and doubtful debts slightly increased as at 30 June 1998 with respect to 31 December 1997 from 9.4 to 9.7 per cent. The same happened to the share of the adjustments in gross assets of banks (from 5.2 up to 5.4 per cent). On the other hand, covering of bad and doubtful debts by value adjustments was somewhat lower as at 30 June 1998 in comparison with the end of 1997 (55.3 per cent or 0.3 percentage points less than as at 31 December 1997), but the volume of allowance provided from income with the aim to cover bad and doubtful debts, is still high and significantly contributes to banks' safety.

In the first half of 1998, the volume of bad and doubtful balance sheet receivables owned to banks outpaced aggregate volume of banking operations. As at 30 June 1998, the rate of growth characterising bad and doubtful balance sheet receivables was 11.2 per cent in comparison with 31 December 1997, while the banking operations growth rate was merely 7.8 per cent.
The number of legal entities and sole traders - customers of banks - was 19,240 at the end of 1997. Following the 6.3 per cent increase, the end-June 1998 figure stood at 20,455.

The average exposure of banks to individual customers rose from the end of December 1997 to the end of June 1998 from SIT 102.4 million to SIT 103.3 million (this figure was SIT 82.2 million without NLB and NKBM).

In the year 1997 and in the first half-year of 1998, banks placed the greatest share of their assets in financial intermediation (approximately 21 per cent), followed by lending to public administration, defence, and social welfare (approximately 15 per cent). Processing industries ranked third (approximately 13 per cent) with metal-processing and the production of metalware, machinery and equipment prevailing. Around 9 per cent of the lending was pumped in trade and vehicle repair business, while real estate business, leases and business services, and other activities, were attracted 5 per cent each.

Credit portfolio in **savings banks** also improved in the period under review, i.e. between the end of 1996 and the end of June 1998, despite more stringent criteria for the classification of on- and off-balance sheet items in both banks and savings banks. When approving a loan application, savings banks are primarily guided by credit standing of the applicant, hence ranking of savings banks' clients practically corresponds to ranking of amounts due from clients (with allowance for first-class security and lien on property pledged as collateral).

As at 31 December 1997 and as at 30 June 1998, almost 90 per cent of receivables were A-graded. The share of B-graded receivables has remained the same over the past two and a half years being around 6 per cent. The share of non-performing assets (on- and off-balance sheet) has declined from almost 8 per cent at year-end 1996 to less than 5 per cent at year-end 1997 and end-June 1998.

Table 8: *Classification of on- and off-balance-sheet assets of savings banks*

in %

Category	*31 Dec 93*	*31 Dec 94*	*31 Dec 95*	*31 Dec 96*	*31 Dec 97*	*30 Jun 98*
A	89.8	91.6	86.2	85.8	88.7	89.5
B	5.9	4.1	7.2	6.3	6.5	6.1
C	1.0	2.2	3.4	3.7	1.3	1.1
D	0.3	0.5	1.3	2.3	1.8	1.8
E	3.0	1.6	1.9	1.9	1.7	1.6

With regard to the end of 1997, the exposure of savings banks as at 30 June 1998 increased by 23.7 per cent, speaking of strong improvement with respect to the end of 1997 in comparison with the end of 1996 (41.2 per cent). Significant expansion of A-grade receivables is mainly due to the practice in some savings banks to underwrite mostly tolar-denominated securities of the Bank of Slovenia. Furthermore, net write-offs also went up amounting to just under SIT 8 million).

Table 8a: *Exposure of savings banks per category and per adjustments/provisions made*

in millions of tolars

Category	*Aggregate exposure* ***31 Dec 1996***	*Adjustments, provisions* ***31 Dec 1996***	*Aggregate exposure* ***31 Dec 1997***	*Adjustments, provisions* ***31 Dec 1997***	*Aggregate exposure* ***30 Jun 1998***	*Adjustments, provisions* ***30 Jun 1998***
A	4,151	0	6,059	0	7,561	0
B	303	31	443	39	512	39
C	181	46	89	23	91	21
D	112	56	120	60	150	76
E	91	91	119	119	133	133
SKUPAJ	4,838	224	6,830	241	8,447	269

The respective shares of bad and doubtful debts, and of value adjustments made with respect to gross assets, have been decreasing since the end of 1996 as the result of improved credit portfolio.

The percentage of bad and doubtful debts covered by adjustment of value was around 40 per cent in savings banks, or considerably better than in banks where this figure was 55 per cent in the period under review.

The volume of bad and doubtful on-balance sheet debts in savings banks increased in the first half of 1998 with respect to the end of 1997 at slower pace than the volume of operations in the same period (14.2 per cent rise in bad and doubtful on-balance sheet debts in comparison with 22.7 per cent growth in the volume of operations measured by total assets). In banks, these figures were just the other way round.

The number of legal entities and sole traders - clients of savings banks - was only slightly higher at end-June 1998 with respect to end-December 1997, thus standing at 371 after adding 8 new customers; average exposure to single client rose in the same period from SIT 7.2 million to SIT 8.1 million.

2.7.1. Provision-making and tax policy

Making provisions[21] for loans and other on-balance-sheet receivables renders valuable protection in the face of potential losses arising from credit and other kinds of inherent risks. Therefore, testing the system of making provisions in place in banks is the centrepiece of banking supervision and prudent banking operations.

[21] The term "provisions" refers both to general and specific provisions and comprises allowance for on-balance-sheet losses, and allowance for off-balance-sheet potential losses.

The examination of general provisions[22], regarded as a security fund to cover potential losses due to risks still unknown, shows that most banks which are not required to make general provisions as their capital adequacy exceeds the prescribed minimum by 20 per cent, still set aside funds to general provisions, although to somewhat lower extent. As at 30 June 1998, general provisions of all banks operating in Slovenia added up to SIT 6.8 billion (as at 31 December 1997, this figure was SIT 6.5 billion, and as at 31 December 1995, it was SIT 6.1 billion).

Amounts stipulated by supervising authorities as mandatory provisions are often the issue of negotiations with tax authorities. In the year 1995[23], selective treatment of banks was implemented when banks claimed reduced tax base. The measure disqualified those banks which exceeded capital adequacy minimum by 20 per cent from charging general provisions made to expenses. The banks having capital adequacy between 14 per cent and 18 per cent could charge up to 50 per cent of general provisions made to expenses, while banks with 18 per cent capital adequacy did not qualify for increasing their expenses on account of provisions.

Following the ruling of the Constitutional Court of the Republic of Slovenia[24], certain stipulations contained in the above law on taxing profit generated by legal entities were abolished. Under the amended law, specific provisions are not taxed, while general provisions were granted a tax break but only until 8 April 1995. After this date, no tax allowance applied to general provisions. Another tax shelter should be mentioned - tax base was reduced by the amount of interest received on long-term securities issued by 8 April 1995 by the Republic of Slovenia, municipalities and public enterprises.

2.8. Off-balance sheet items

Risk-weighted off-balance-sheet items classified in accordance with the Decree on the Classification of On- and Off-balance Sheet Items of Banks and Savings Banks (Official Gazette of the Republic of Slovenia, Nos. 78/96 and 49/98) encompass issued guarantees, endorsements, letters of credit, irrevocable commitments assumed under granted loans and agreed unused overdrafts, and other contingent liabilities which may be grounds for incurring the bank's liability to effect payment. Risk-weighted on- and off-balance-sheet items are graded in groups ranging from the least risky (A-grade) to the most risky (E-grade).

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[22] The bank shall make general provisions in the amount of at least 1 per cent of receivables classified as A-grade on the basis of the Decree on the Classification of On- and Off-Balance Sheet Items of Banks and Savings Banks (Official Gazette of RS, Nos. 78/96, 49/98), with the exception of receivables due from the Bank of Slovenia or the Republic of Slovenia. On the other hand, the bank is currently not required to make provisions if its capital-adequacy ratio exceeds 9.6 per cent (20 per cent above minimum capital adequacy). In compliance with the Amendment to Decree on the Amount of Provisions and the Method to Calculate Provisions to Protect Banks and Savings Banks Against Potential Losses (Official Gazette of RS, No. 49/98), banks shall make general provisions equalling at least 1% of their receivables classified as A-grade by 31 December 2000, irrespective of their capital adequacy.
[23] Amendment to the Law on Corporation Tax (Official Gazette of the Republic of Slovenia, No. 20/95).
[24] Official Gazette of the Republic of Slovenia No. 27/98.

Off-balance sheet items of **banks** were continuously increasing between 1993 until the end of 1995. Particularly sharp rise was recorded as at 31 December 1995, when the year-on-year increase was 18.6 per cent. At the end of 1996, off-balance sheet commitments fell by approximately SIT 8 billion in comparison to 31 December 1995, but bounced back over the year 1997. The latest year-end figure was SIT 382.6 billion.

As at 31 December 1997, off-balance-sheet contingent liabilities and commitments composed more of foreign currency- than tolar-denominated liabilities, represented less than one fifth of balance sheet receivables.

Over one half of off-balance-sheet items were guarantees, and almost 73 per cent of them issued in foreign currency. As opposed to the previous year, the aggregate amount of guarantees denominated in foreign currency was somewhat lower (by 6.7 per cent), while the tolar-denominated amount of guarantees increased (by 24.4 per cent). Total number of guarantees, however, has remained unchanged, i.e. at the level reported at the end of 1996.

Further analysis of commitments and contingencies as at 31 December 1997 shows that undertaken irrevocable commitments for granted but unused credit lines account for some 33 per cent of total off-balance-sheet liabilities. Practically all these liabilities are denominated in tolars. If irrevocable commitments are ranked on the basis of growth rate, they come second with 34.2 per cent, right after guarantees, and after other contingent liabilities being mostly forward transactions.

Other off-balance-sheet commitments soaring by more than a half at the end of 1997 as opposed to the end of 1996, amounted to SIT 30 billion and were ranked on the third place in terms of importance but account for less than 8 per cent of all off-balance sheet commitments. Other memorandum items were mostly denominated in foreign currency and may be practically charged to one bank and forward transactions only.

Letters of credit accounted at the end of 1997 for just over 5 per cent of total off-balance sheet commitments. As at end-1997, not a single tolar-denominated letter of credit was on the books. The growth in the number of letters of credit issued was moderate - 4.9 per cent.
Endorsed and accepted bills of exchange shrank at the end of 1997 as opposed to the end of 1996 by 18.1 per cent totalling just under SIT 1.5 billion. With few exceptions, bills of exchange were denominated in foreign currency.

Table 9: *Risk profile of off-balance-sheet items of banks*

in millions of tolars in %

		Amount		Nom. growth
Off-balance-sheet items		31 Dec 1996	31 Dec 1997	1997/1996
Guarantees	SIT	44,533	55,389	24.4
	Forex	159,562	148,812	-6.7
Total		***204,095***	***204,201***	***0.1***
Letters of credit	SIT	6	0	
	Forex	19,967	20,957	5.0
Total		***19,973***	***20,957***	***4.9***
Endorsed and accepted	SIT	58	13	-77.6
bills of exchange	Forex	1,770	1,484	-16.2
Total		***1,829***	***1,497***	***-18.2***
Irrevocable commitments assumed	SIT	90,900	118,549	30.4
	Forex	2,932	7,389	152.1
Total		***93,831***	***125,939***	***34.2***
Other	SIT	2,066	3,261	57.9
	Forex	17,062	26,790	57.0
Total		***19,127***	***30,051***	***57.1***
TOTAL	SIT	137,562	177,213	28.8
	Forex	201,293	205,431	2.1
GRAND TOTAL		***338,855***	***382,644***	***12.9***

Off-balance sheet items in **savings banks** accounted for less than 1 per cent of risk-weighted on-balance-sheet liabilities amounting to mere SIT 35.7 million at end-1997. All off-balance-sheet items were underwritten in tolars, being mostly irrevocable commitments (almost 66 per cent of risk-weighted off-balance-sheet items) and guarantees. The latter decreased by almost 80 per cent for the period ended 31 December 1997 in comparison with 31 December 1996, thus reducing total risk-weighted off-balance-sheet items by more than 70 per cent at end-1997 as opposed to end 1996. As at 30 June 1998, savings banks partially off-set the drop in risk-weighted off-balance-sheet items, but failed to achieve the results reported in 1996, the record-high year since 1993.

Table 10: *Risk profile of off-balance-sheet items of savings banks*

in millions of tolars in %

	Amount		Nom. growth
Off-balance-sheet items	31 Dec 96	31 Dec 97	1997/1996
Guarantees	95	12	-87.4
Irrevocable commitments assumed	27	24	-11.1
TOTAL	***122***	***36***	-70.5

2.9. Country risk

Provisions of the Decree on the Classification of On- and Off-balance Sheet Items of Banks and Savings Banks (Official Gazette of the Republic of Slovenia, Nos. 78/96, 49/98), effective from 1 January 1997, stipulate that country risk shall be incorporated in amounts due from foreign persons. Specific provisions to act as a buffer against cross-border exposure are calculated on the basis of minimum standards recommended by the Bank of Slovenia and derived from the country-risk assessment. Country credit rating is the combination of evaluations made in the Slovenian Export Corporation, the Centre for International Co-operation and Development, and internationally recognised rating institutions.

Banks make adjustment of value and provisions as allowance for aggregate credit and country risk. The aggregate allowance for possible credit losses maintained by each bank shall be equal to the sum of country risk and individual risk inherent in each client of a bank or savings bank.

The amendment to the said Decree dated June 1998 elaborated on the circumstances which release banks from the obligation to make adjustments of value and provisions for country risk in the following cases:

- first-class security[25] has been pledged,
- exposure arises from contracted repayment period of up to 6 months,
- exposure arises from lending to a branch of prime foreign bank,
- exposure arises from lending to a client with A-grade creditworthiness against first-class security.

Aggregate exposure of banks to foreign persons in the period from 31 December 1996 to 30 June 1998 has fallen by 25 per cent - from SIT 318.7 billion to SIT 239.2 billion. During the period under review, exposure to all international associations of countries - EU, EFTA, CEFTA, etc. - was reduced, while exposure to the republics of former Yugoslavia rose by 30.3 per cent.

As at 30 June 1998, exposure of Slovenian banks to foreign persons from Member States of the European Union accounted for nearly 76 per cent of aggregate exposure. Exposure to entities from the EU within aggregate exposure totals to SIT 180.7 billion, or 9 per cent less than the reported as of 31 December 1997 and almost 31 per cent less than at end-1996.

Exposure of Slovenian banks to foreign persons from Members States of EFTA as at 30 June 1998 amounted to SIT 16.7 billion, or 7 per cent of aggregate exposure of Slovenian banks to foreign entities.

Exposure of banks to persons from the republics of former Yugoslavia grew by hefty half billion tolars between 31 December 1997 and 30 June 1998 to SIT 16.1 billion - a rise of 3.7 per cent.

[25] ***First-class security:*** bank deposits, securities issued by the Republic of Slovenia, the Bank of Slovenia, and most OECD countries, irrevocable guarantees, debentures, irrevocable sureties issued by the Slovenian Export Corporation, and irrevocable sureties of the Republic of Slovenia.

Exposure to persons from the CEFTA countries remained practically unchanged during the period under review, standing at 0.5 per cent of aggregate exposure of Slovenian banks.

As at 30 June 1998, exposure of Slovenian banks to foreign persons in other countries equalled SIT 24.6 billion (exposure to persons from the USA headed the list with SIT 19 billion, followed by exposure to persons from the Russian Federation with SIT 3.1 billion), or barely 10 per cent less than as at 31 December 1997.

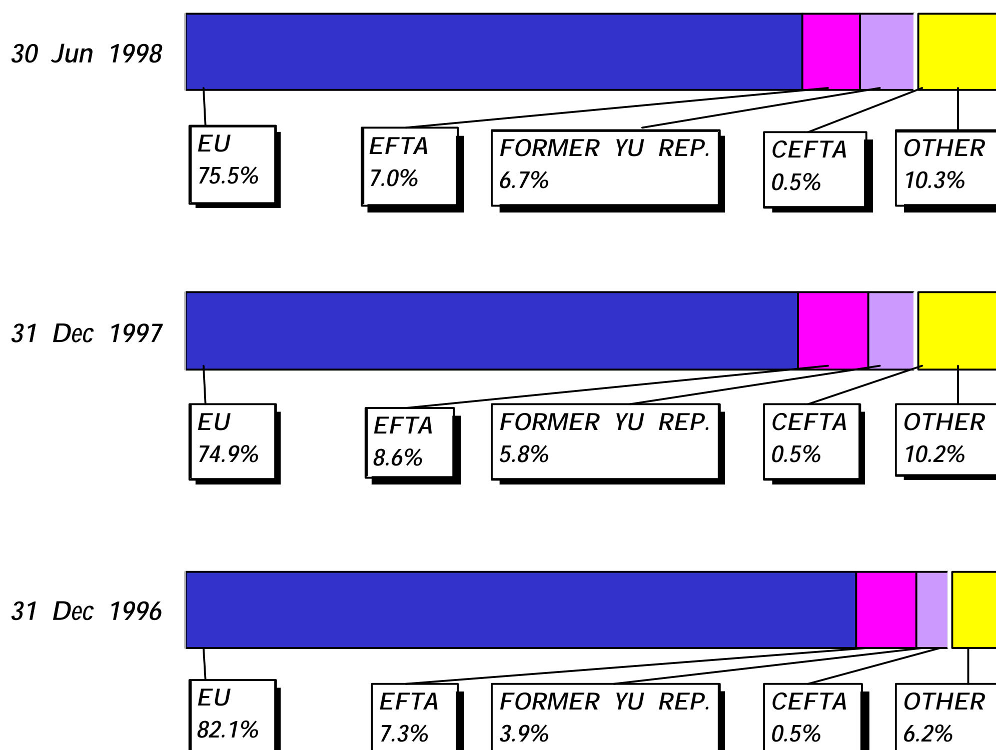
Table 11: *Aggregate exposure of banks to groups of countries, share of exposure in aggregate exposure and nominal growth rate*

in millions of tolars, in %

	Amount	Share	Amount	Share	Nom. growth	Amount	Share	Nom. growth
	31 Dec 96		**31 Dec 97**		**1997/1996**	**30 Jun 98**		**1H1998/1997**
EU	261,607	82.1	199,058	74.9	-23.9	180,661	75.5	-9.2
EFTA	23,145	7.3	22,747	8.6	-1.7	16,737	7.0	-26.4
Former YU Republics	12,358	3.9	15,535	5.8	25.7	16,103	6.7	3.7
CEFTA	1,502	0.5	1,229	0.5	-18.2	1,109	0.5	-9.8
Other	20,100	6.3	27,197	10.2	35.3	24,582	10.3	-9.6
TOTAL	318,712	100	265,766	100.0	-16.6	239,192	100.0	-10.0

Aggregate allowance of banks to absorb credit losses due to country risk (irrespective of first-class security), would amount to SIT 6.1 billion at end-1996, SIT 9.8 billion at end-1997, and SIT 9.6 billion at end-June 1998. In reality, banks have set aside lower provisions to safeguard against country risk on account of lending considered to be A-grade.

Figure 6: *Exposure of banks to country risk*



Since **savings banks** are not authorised to carry out cross-border payments and lending operations, there is no exposure to country risk.

2.10. Liquidity risk

The ability of banks and savings banks to have sufficient funds readily available to repay liabilities as they mature improved in the period under review, thus diminishing liquidity risk across banking industry in Slovenia.

2.10.1. Compliance with the mandatory reserves and foreign currency minimum

In 1997, allocation of funds to mandatory reserves was met by all banks, while savings banks failed to meet the requirement on three occasions.

During the first half of 1998, all banks complied. Among savings banks, there was only once case of non-compliance.

Reserves of banks and savings banks exceeded monthly liabilities in 1997 by 5.0 per cent on average, and by 3.8 per cent on average in the first half of 1998.

Through 1997, banks complied with foreign currency minimum amounting to SIT 325.7 billion in the beginning of the year. The minimum requirement was increased to SIT

335.7 billion as at 30 June 1997, and at year-end 1997 it stood at SIT 352.3 billion. At end-June 1998, the amount was SIT 362.9 billion. Foreign-currency requirement has been growing mostly due to swelling of payment transactions with foreign countries rising from 17.0 per cent at end-December 1996, to 19.1 per cent at end-June 1998. Savings deposits in foreign currency from domestic persons (time deposits up to one year) were also reflected in banks' books and benchmarking.

The 1997 statutory foreign currency requirement was comfortably exceeded by between 15.6 and 23.5 per cent. A steady upward trend in foreign exchange liquidity persisted also in the first two quarters ended June 1998 when the statutory minimum was exceeded by 9 per cent.

2.10.2. Short-term planning of tolar-liquidity flows and maturity structure

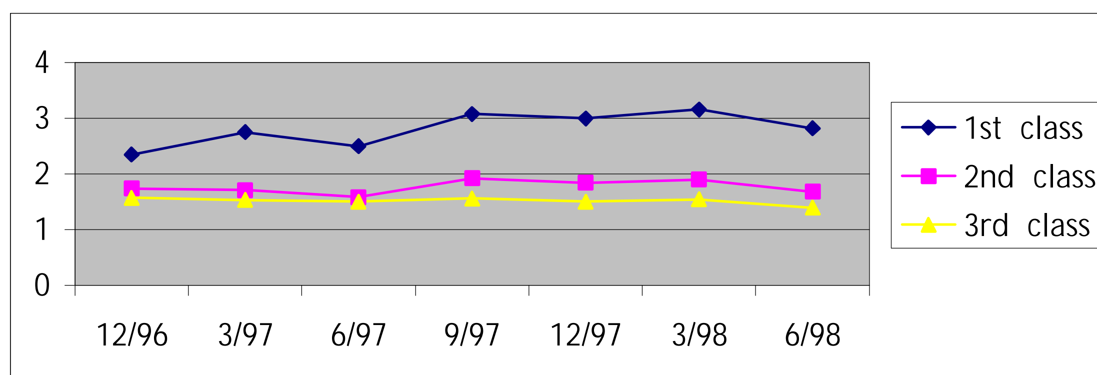
Although banks are left to their own devices when setting-up their liquidity-risk management, the Bank of Slovenia exercises constant vigilance over daily cash monetary flows by examining statutory plans for liquid-asset management submitted by banks daily for the current day and for two following workdays. Most banks have improved their assessment of sources of liquid funds and methods to project the volatility of funding and reduce potential mismatch, as the gap between planned and actual flows are narrowing.

The Decree on the Required Adjustments of the Maturity Structure Between Assets and Liabilities sets forth provisions for the adjustment of assets maturity with sources of funds[26]. The said Decree has been effective since 1 August 1996 as a part of comprehensive efforts to avert potential funding problem. As at 31 December 1996, eight banks and five savings banks reported maturity mismatch in sources and the application of funds. A decrease in the maturity mismatch as the result of improved planning was confirmed as at 30 June 1998 when all banks[27] and three savings banks reported balanced maturity structure. Improved matching of maturity of assets and sources of funding of banks - primarily in the best and the second best category - was maintained during the period under review, with the exception of June and December 1997, and June 1998.

[26] The Decree classifies assets and liabilities into the first, second, and third class. Ranking depends on maturity structure. First-class assets comprise assets payable on demand and those claims which are eligible for re-financing in case of emergency by the central bank. Second-class assets include first-class assets and claims repayable within 30 days, while third-class assets include first- and second-class assets and claims due within 180 days.

[27] Some banks - members of a banking group classify liquidity loans taken from parent bank in all three classes.

Figure 7: *Quality of assets and liabilities of banks*



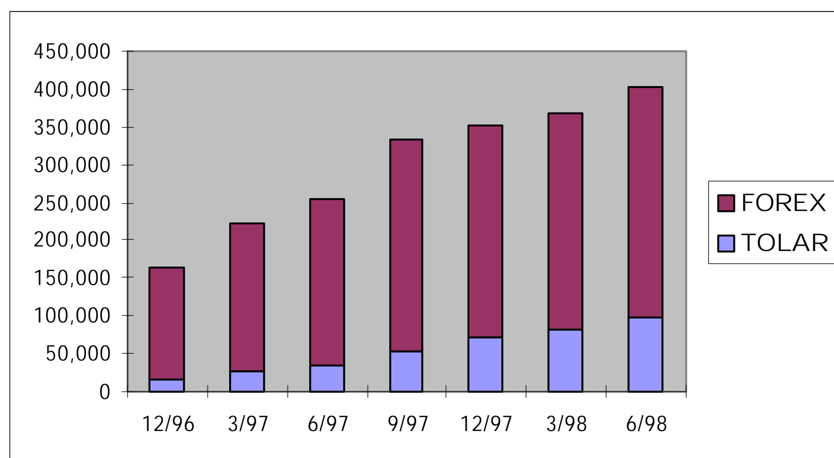
2.10.3. Secondary liquidity

Lines of funding described as secondary liquidity[28] are regarded as stand-by instruments which reduce over-reliance on deposits for liquid assets. Gilt-edged securities may be used at any time to obtain a loan to bridge short-term fluctuations. The Bank of Slovenia provides funding of short-term liquidity short-falls against bills of the Bank of Slovenia and bonds of the Republic of Slovenia.

Secondary liquidity being at rather low level at year-end 1996 (SIT 163.8 billion), recorded strong growth in the first half of 1997, and at year-end it amounted to SIT 353,3 billion. The trend continued also in 1998, and at end-June 1998, the amount was SIT 401.5 billion. As much as 62.8 per cent and 61.1 per cent of aggregate assets under secondary liquidity as at 31 December 1997 and 30 June 1998, respectively, was held by seven major banks in Slovenia. At the end of June 1998, the share of assets classified as secondary liquidity amounted on aggregate average in all banks to 18.4 per cent of total assets.

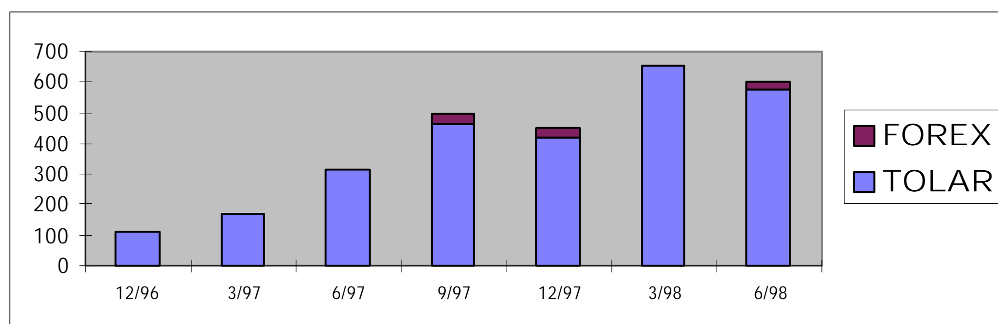
[28] Secondary liquidity includes investments in securities issued by the Bank of Slovenia and the Republic of Slovenia in domestic and foreign currency (bills of the BoS and RS, short-term bonds of RS), accounts 1340, 1342, 1350, 3030, 3031, 3032, 3300, 3301, 431, 4340.

Figure 8: *Secondary liquidity of banks (in millions of tolars)*



In 1997, **savings banks** followed suit increasing their supplementary liquidity reserves composed of central bank bills. Secondary liquidity of savings banks standing at SIT 109.7 million at the end of 1996, rose to SIT 449.0 million by the end of 1997, and to SIT 602.4 million at the end of June 1998.

Figure 9: *Secondary liquidity of savings banks (in millions of tolars)*



2.10.4. Major Depositors

Banks' statutory returns listing thirty largest depositors indicate the reliance of most banks on few major depositors. The growing share of retail deposits mitigates liquidity risk owing to dispersion (many accounts with low amounts), and low volatility of deposited funds.

The concentration of funding varies from one bank to another. Albeit the share of thirty largest depositors in aggregate deposit amount in the banking system (banks and natural persons excluded) decreased for the average calculated for all banks from 54.3 per cent at half-year 1997, to 53.3 per cent at year-end 1997, it rose again after the first two quarters in 1998 to 53.9 per cent. Relatively high sensitivity of banks to large depositors is counterbalanced by adequate application of deposited funds and proper maturity structure.

The data reported for the period ended 30 June 1998 show that in seven banks the share of top five depositors (banks and natural persons excluded) accounts for more than one half of all deposits. This means that 41.8 per cent of deposits made by largest depositors of all banks as at 30 June 1998 matured by the end of August 1998, whereas the maturity of the remaining portion spreads over a longer period.[29]

2.10.5. Management of liquidity risk within banking groups

Facilities available to a bank - member of a banking group - to bridge fluctuations in funding are defined in the liquidity agreement. Such agreements on financial assistance to a bank inside the banking group faced with liquidity problems foresee different tools for particular cases, while general provisions draw a demarcation line between the management of liquidity in the normal course of business (regular interbank lending), and the accommodation required by another member of the banking group to settle outstanding positions.

For the purpose of regular interbank lending, members of a banking group have set up a framework under which a bank - member of a banking group - shall first look for accommodation instruments inside its banking group, and only afterwards in the interbank market.

All cases of mutual funding outside the regular interbank money market shall be reported to the Bank of Slovenia by the leading bank in the banking group. Fixing the ceiling of accommodation within the banking group, as well as other terms and conditions pertinent to such funding, is set forth in the agreement binding upon all member banks.

2.11. Solvency risk

Over a period ended 31 December 1995, capital adequacy[30] was rising constantly throughout the banking industry in Slovenia as a result of the policy endorsed by the Bank of Slovenia demanding strong regulatory capital from all institutions engaged in banking operations. Following the rise of capital adequacy in **banks** at the end of 1995 as opposed to the end of 1994 (from 20.5 to 21.5 per cent), due to re-capitalisation of most banks in Slovenia, capital adequacy across the sector fell at year-end 1996 to 19.7 per cent and continued the downward trend until 30 June 1998. Thus capital adequacy was 19.0 per cent as at 31 December 1997, while on 30 June 1998, it dropped to 17.6 per cent.

The decrease in capital adequacy from year-end 1996 until year-end 1997 is the consequence of the faster growth of risk-weighted assets (rising by 15.8 per cent) with

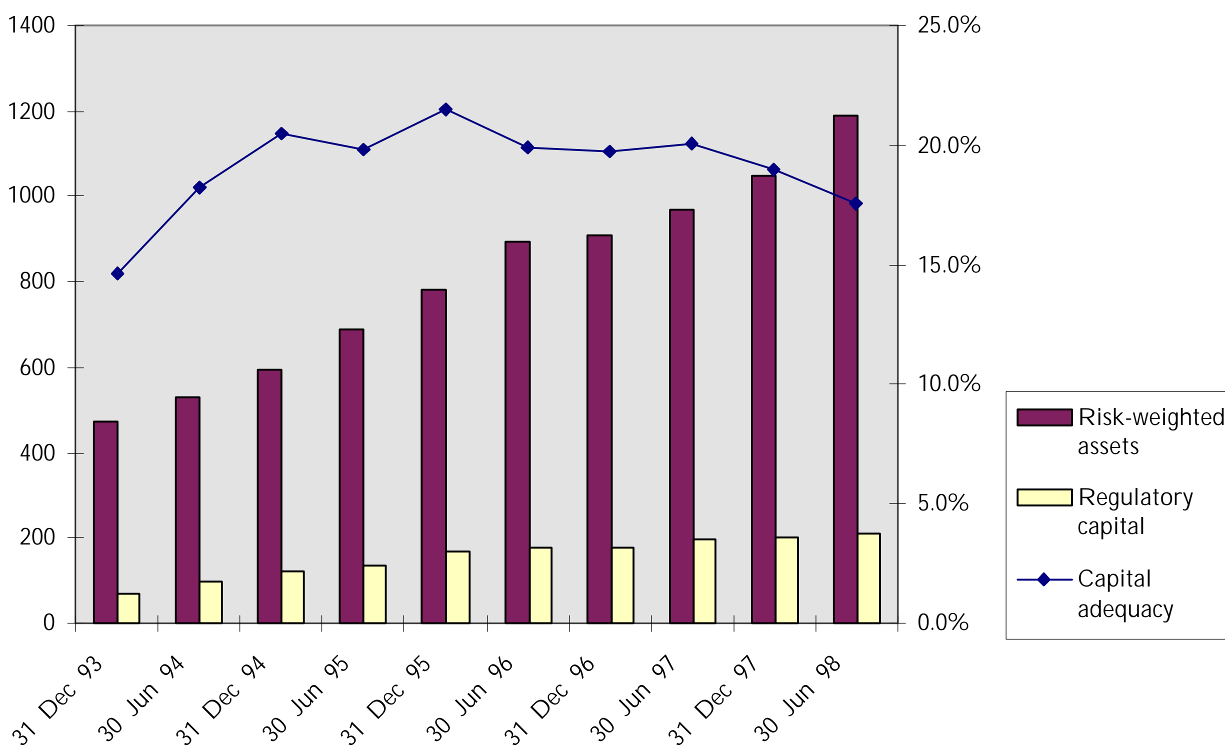
[29] By end-September 1998, 8.2% of deposits are due, by end-October 1998 - 4.8% deposits, and after October 1998 - 45.2% of all deposits mature.
[30] Capital adequacy is computed as a ratio of the total amount of regulatory capital and the total amount of risk-weighted assets. Pursuant to the Law on Banks and Savings Banks, total regulatory capital shall be at least 8% of total assets and off-balance-sheet items, classified and indexed according to risk-weight.

regard to the growth of regulatory capital (rising by 11.3 per cent). At half-year 1998, the growth of risk-weighted assets (13.0 per cent) outpaced the growth of regulatory capital (4.8 per cent), resulting in lower capital adequacy in comparison with 31 December 1997.

The capital-adequacy ratio for the Slovenian banking system has been high on average, thus enabling banks to manage new risks by deploying own funds. In other words, adequately capitalised banks mean that safety net provided to absorb both recognised and potential losses offers more protection to depositors and other providers of loan finance. At the same time, the existence of adequate capital enable further growth of risk-weighted assets with respect to regulatory capital.

As at 30 June 1998, no bank in Slovenia reported capital-adequacy ratio below 9.6 per cent - the bottom value required to make general provisions - but this figure varies significantly from one bank to another. At the end of June 1998, banks reported the capital-adequacy ratio in the range from 10.0 per cent to 54.2 per cent.

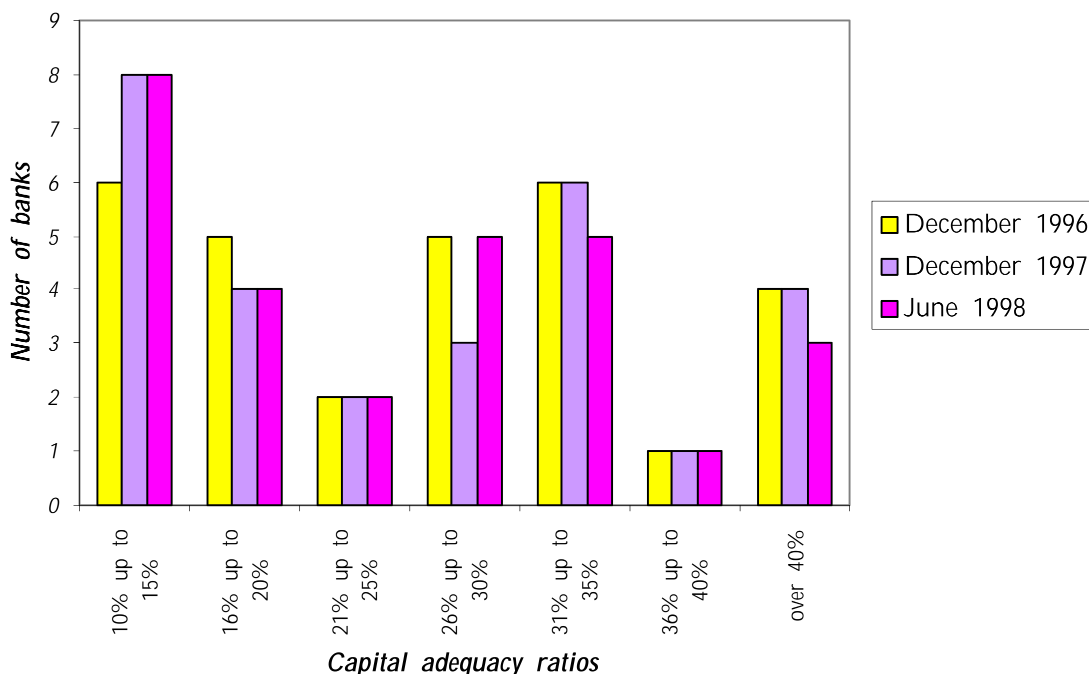
Figure 10: *Movements in risk-weighted assets and regulatory capital (in billions of tolars) and capital adequacy*



Distribution of banks in terms of capital adequacy indicates a shift towards an increase in the share of banks with lower capital-adequacy ratios. At the end of 1996, most banks had capital adequacy between 10-15 per cent and between 31-35 per cent (21 per cent of banks), at the end 1997, the share of banks with capital-adequacy ratio between 31 per cent and 35 per cent remained unchanged, while the share of banks

with capital-adequacy ratio between 10 per cent and 15 per cent is on the rise. At the end of June 1998, the share of banks with the lowest capital-adequacy ratios (10-15 per cent) was the same as at year-end 1997 (29 per cent); the share of banks with the capital-adequacy ratio between 31 and 35 per cent rose by 18 per cent at the expense of the banks whose capital-adequacy ratio was between 26 and 30 per cent.

Figure 11: *Distribution of banks in terms of capital adequacy*



Savings banks recorded on average lower capital-adequacy ratio than banks. Namely, 14.5 per cent and 13.6 per cent as at 31 December 1997 and 30 June 1998, respectively. The range of capital-adequacy ratios between savings banks is also less ample than between banks - as at 30 June 1998, the capital-adequacy ratio ranged between 9.6 per cent and 35.2 per cent.

2.12. Interest-rate risk

At the end of 1997, non-interest earning assets[31] of **banks** accounted for 11.4 per cent of aggregate total assets of the Slovenian banking system, while its complementary part (interest-earning assets[32]) accounted for 88.6 per cent of total assets. Non-interest earning assets reported as at 31 December 1997 grew in comparison with the balance reported for the period ended 31 December 1996 by 0.3 percentage point. In the same period, interest-earning assets decreased by 0.3 percentage points. Auditors' reports show that the portion of non-interest earning liabilities[33] dropped as at 31 December 1997 to 18.3 per cent from 17.7 per cent recorded as at 31 December 1996 of aggregate total assets of the Slovenian banking system, whereas the portion of interest-earning liabilities[34] filled the gap by rising from 81.7 per cent to 82.3 per cent.

At the year-end 1997, net exposure of Slovenian banks to interest-rate risk shows year-on-year rise from SIT 124.2 billion to SIT 128.5 billion, meaning 3.5 per cent increase of net exposure to interest-rate risk. In other terms, the difference between interest-earning assets and interest-earning liabilities grew by SIT 4.3 billion.

Interest-earning assets amounted to SIT 1,791.5 billion at 31 December 1997. With regard to maturity structure, interest-earning assets fall into the following groups: loans and advances repayable on demand dropping since 31 December 1996 from 8.3 per cent to 6.9 per cent, loans and advances falling due in one month rising from 26.0 per cent to 27.9 per cent in the year under review, loans and advances falling due in three months, loans and advances falling due in three to twelve months and loans and advances over one year. Loans and advances due in three months grew from 11.5 per cent (as at 31 December 1996) to 12.8 per cent (31 December 1997), loans and advances due between three and twelve months increased from 14.7 per cent to 20.3 per cent, while loans and advances over one year declined from 39.5 per cent to 32.2 per cent.

Loans and advances maturing after one year fell sharply during the year under review - by 18.5 per cent. The opposite trend was reported in the category of loans and advances maturing between three and twelve months - sharp rise of as much as 38.1 per cent.

The bulk of interest-earning assets as at 31 December 1997 comprised loans and advances falling due after one year. Lending due in one month's time followed suit.

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[31] *Noninterest-earning assets* comprise cash in hand and balances with central bank, state bonds and other securities eligible for discount at central bank, investments in affiliates, investments in subsidiaries, intangible long-term assets, tangible fixed assets, and other assets.

[32] *Interest-earning assets* comprise loans and advances to banks and savings bank, loans and advances to customers other than banks, investment securities, securities held for dealing purposes.

[33] *Noninterest-bearing liabilities* comprise accruals and deferred income, general and specific provisions, subscribed capital and foundation capital of savings banks, share premium account, bank's reserves, capital revaluation adjustment, net profit or loss carried forward from previous years, profit or loss for the financial year and other liabilities.

[34] *Interest-bearing liabilities* comprise liabilities to banks in savings banks, liabilities to customers other than banks, and liabilities arising from issued securities and certificates of deposit.

Loans and advances repayable on demand trailed behind accounting for the smallest share of banks' assets bearing interest.

Interest-bearing liabilities of banks as at 31 December 1997 equalled SIT 1,663.0 billion. Funds repayable on demand accounted for 20.7 per cent of interest - bearing liabilities, liabilities maturing within one month accounted for 30.2 per cent, liabilities maturing between one and three months accounted for 15.2 per cent, liabilities maturing from three to twelve months accounted for 19.5 per cent, and liabilities maturing after one year and bearing interest to banks' customers accounted for 14.4 per cent of interest - bearing liabilities. The analysis of the maturity structure of banks' liabilities shows the most noticeable fall in banks' liabilities maturing after one year - by as much as 27.6 per cent. On the other hand, the most vigorous growth is noticeable in the category of liabilities maturing within three months to one year - by as much as 30.9 per cent.

The most important part of interest-bearing liabilities are funds falling due within one month, with liabilities repayable on demand placed second, liabilities due between three months and one year being on the third place, liabilities due between one month and three months on the fourth place, followed by liabilities over one year.

Audited annual reports of banks for the year 1997 disclose that only few banks had in place proper asset and liability management, i.e. adequate tools for monitoring interest-rate exposure and efficient control of risk associated with interest-earning assets and interest-bearing funds.

Quite a large number of banks enters into contracts containing floating interest-rate clause both on the assets and the liabilities side.

Figure 12: Maturity structure of interest-earning assets and liabilities as a share of aggregate total assets of the Slovenian banking system as at 31 December 1996

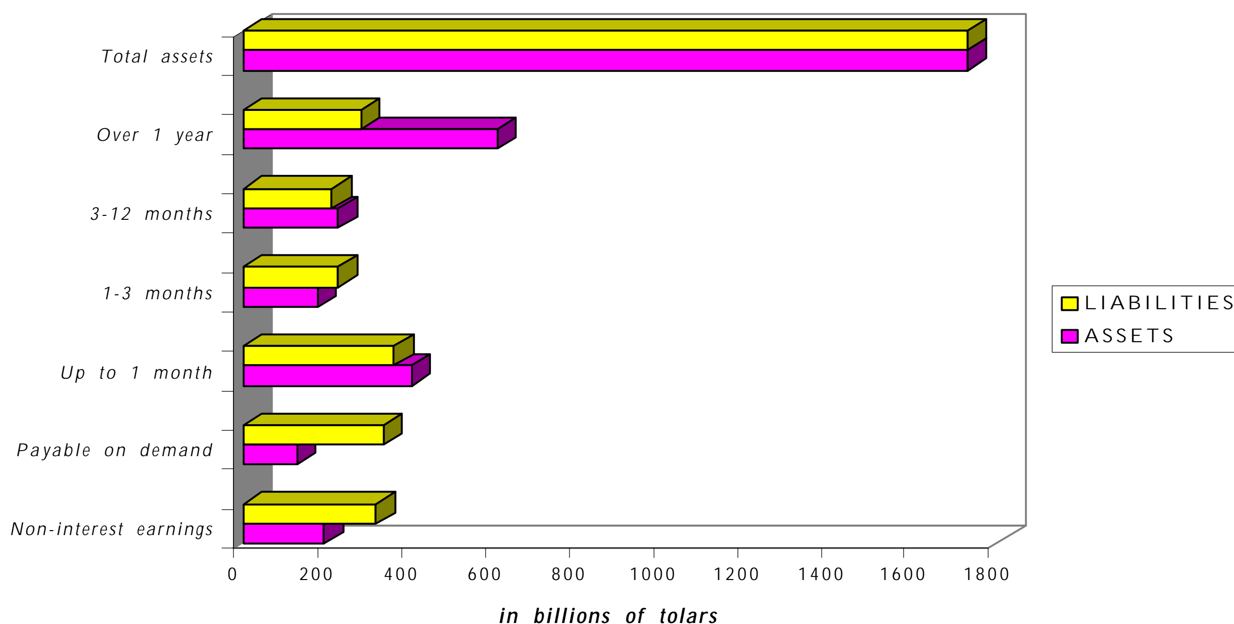


Figure 13: *Maturity structure of interest-earning assets and liabilities as a share of aggregate total assets of the Slovenian banking system as at 31 December 1997*

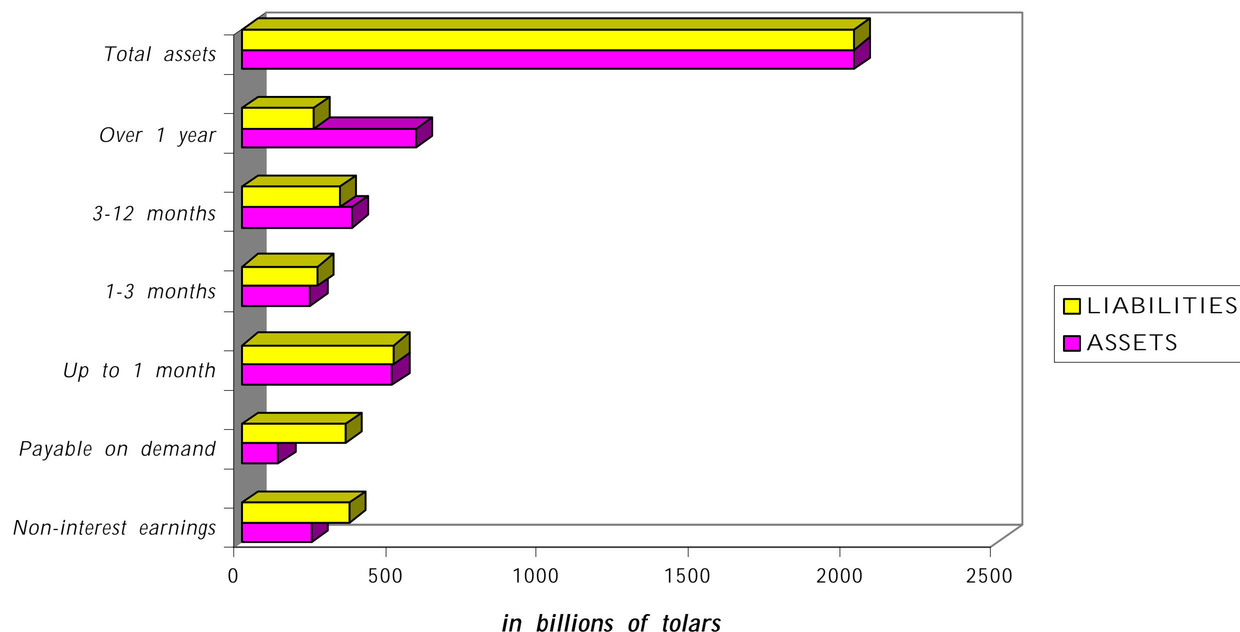


Figure 14: *Structure of share of maturity period with respect to total assets as at 31 December 1996*

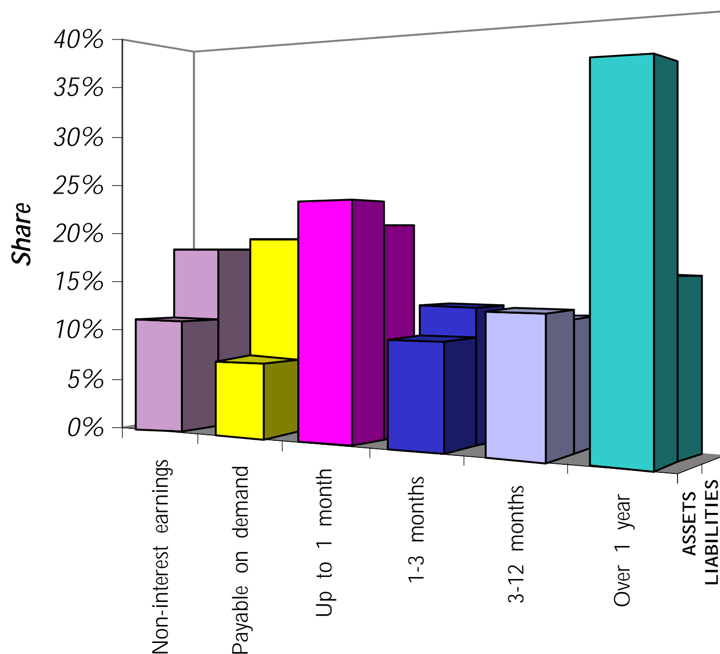
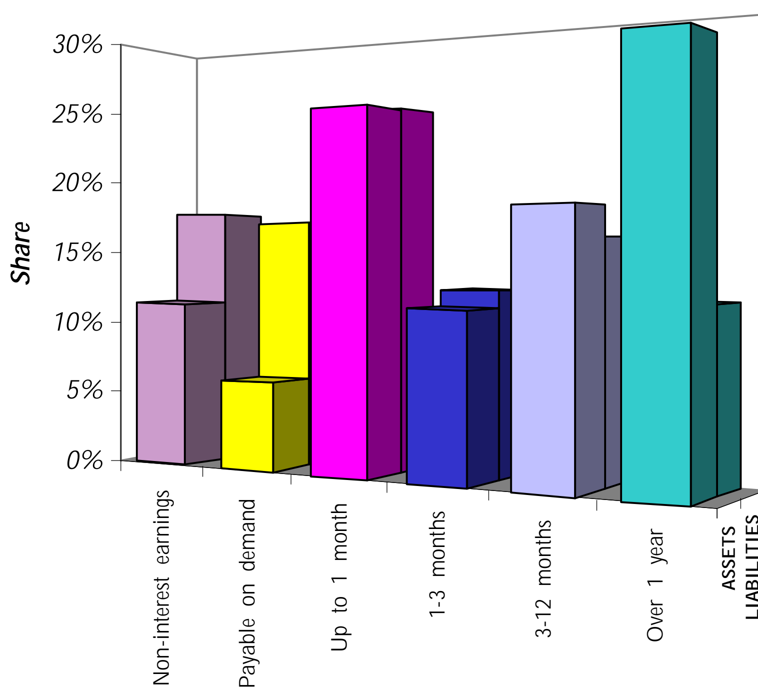


Figure 15: *Structure of share of maturity period with respect to total assets as at 31 December 1997*



At end-1997, total assets of **savings banks** equalled SIT 7.2 million, whereas 8.4 per cent of total assets were non-interest earning assets, and 91.6 per cent of total assets were interest-earning assets. On liabilities side, 13.7 per cent of total funds did not bear interest, while 86.3 per cent of on-balance sheet liabilities were interest-bearing. The year-on-year comparison of the exposure of savings banks to interest-rate risk shows that non-interest earning assets declined by 1.7 percentage points, while non-interest bearing liabilities recorded a shaper drop - by 3.6 percentage points

Loans and advances maturing between three months and one year prevailed in the category of interest-earning assets (33.2 per cent), followed by funds repayable on demand (25.1 per cent), loans and advances maturing after one year (20.5 per cent), loans and advances maturing within three months (11.3 per cent), and loans and advances maturing within one month (9.9 per cent). The sharpest drop noticeable between 31 December 1996 and 31 December 1997 on assets side was recorded by funds repayable on demand. The decrease during the year under review was by 24.6 per cent or by 8.2 percentage points. The steepest rise was recorded by loans and advances maturing within one month - 54.7 per cent.

The most important interest-bearing liabilities as at 31 December 1997 were funds maturing between three months and one year (37.9 per cent), followed by funds repayable on demand (30.1 per cent), funds repayable from one to three months (16.6 per cent), funds maturing after one year (9.1 per cent), and funds maturing within one month (6.3 per cent). The steepest rise in liabilities of savings banks from 31 December 1996 to 31 December 1997 was noticeable in liabilities maturing from three to twelve months where the increase was as much as 77.1 per cent. This category was also the only group of obligations rising in year-on-year comparisons. The opposite trend was acknowledged in funds maturing within the period from one to three months where obligations plunged by 34.9% per cent.

Whereas the balance in movements in receivables and payables over the same time intervals was observed in banks, it was not the case in savings banks. Banks were stepping up receivables and payables falling due between three and twelve months, and decreasing receivables and liabilities over one year. In savings banks receivables due within one month increased, and the same was happening to payables due between three and twelve months, while receivables payable on demand and payables due between one and three months declined.

A similar mismatch is evident also in the current balance of receivables and payables reported by banks and the same balance reported by savings banks. Receivables maturing after one year prevailed in banks as at 31 December 1997 standing at 32.2 per cent of total assets, while in savings banks receivables due within three to twelve months prevailed (33.2 per cent). Funds repayable on demand account for meagre 6.9 per cent among banks' receivables, while in savings banks funds falling due within one month with only 9.9 per cent are on the bottom of receivables.

As at 31 December 1997, banks had the bulk of liabilities in the category of funds maturing within one month (30.2 per cent), while savings banks had most liabilities in the category maturing within three to twelve months (37.9 per cent). The smallest share of liabilities in banks is in the category maturing after one year (14.4 per cent);

in savings banks, funds maturing within one month account for the smallest share in liabilities with only 6.3 per cent.

2.13. Currency risk

1. Foreign currency mismatch in banks

Balance-sheet items of **banks** denominated in foreign currency indicate an inherent foreign currency mismatch or net open position in foreign currency to be regarded as the exposure of banks to currency risk. An analysis of the so-called foreign currency sub-balance highlighting the exposure of banks to currency risk as at 31 December 1997 shows that liabilities in foreign currency exceeded by SIT 51.8 billion assets in foreign currency[35], which means that the average net position of banks in foreign currency was short. Net exposure of banks to exchange or currency risk narrowed over a year's period by 48.8 per cent since as at 31 December 1996, the position in foreign-currency instruments equalled SIT 101.1 billion. The net open position as at 31 December 1997 reached 26.0 per cent of regulatory capital of Slovenian banks, or a half less than in the previous year when the net open position in foreign currency as at 31 December 1996 soared to 56.4 per cent of regulatory capital maintained by Slovenian banks.

In accordance with the Decree on the Mismatch between Assets and Liabilities of Banks in Foreign Currency (open foreign currency position), (Official Gazette of the Republic of Slovenia Nos. 35/97, 79/97, 15/98, 31/98, 37/98 and 42/98), in full force and effect since 15 June 1997, banks conducting operations with foreign-currency instruments shall calculate their daily open position in foreign currency. Daily short or long position in foreign currency shall not exceed 20 per cent of regulatory capital of the respective bank. As at 15 June 1997, the net open position in foreign currency overshot the ceiling of 20 per cent of regulatory capital in seventeen banks, as at 31 December 1997, there were nine such banks, while as at 30 June 1998, the number of banks exceeding the limit fell to seven. Pursuant to the above-mentioned Decree, banks were originally given time to close the gap in their open position in foreign currency to 20 per cent of regulatory capital by 01 July 2002. The examination of the banks' statutory returns showed that the period left to banks to close their open position in foreign currency could be shortened first to 1 January 2000 (Official Gazette of the Republic of Slovenia No. 79/97), and eventually to 1 July 1999[36] (enacted on 30 May 1998).

[35] Out of the total SIT 654.2 billion being the tolar equivalent for receivables denominated in foreign currency as at 31 December 1997, DM-denominated amounts accounted for 64%, USD accounted for 21.4%, while the share of other currencies was 14.6%. On the same day foreign-currency equivalent for tolar-denominated receivables amounted to SIT 706.1 billion - DM-denominated amounts accounted for 63.5%, USD-denominated amounts accounted for 19.7%, while other currencies accounted for 16.8%

[36] After 30 June 1998, an amendment to the Decree was promulgated in the Official Gazette of RS, No 65/98, stipulating that until 2 October 1998, short or long position of the bank in foreign currency shall not exceed 20% of its regulatory capital. Therefore, there is no transition period for compliance.

2. *Mismatch in transactions with foreign currency clause*

Balance-sheet items denominated in tolars show net exposure as the balance between items in tolars on the assets and on the liabilities side under contracts with foreign-currency clause recorded as at 31 December 1997 and designated as long position with foreign currency clause. Tolar-denominated assets with foreign-currency clause exceeded as at 31 December 1997 tolar-denominated liabilities with foreign-currency clause by SIT 44.6 billion, or 62.5 per cent decrease with respect to 31 December 1996.

3. *Aggregate exposure to currency risk*

Aggregate net exposure to fluctuations in exchange rates (foreign currency mismatch and foreign currency clause) amounted at the end of 1997 to SIT 7.2 billion. At end-1997, banks had in average the so-called long aggregate exposure to currency risk, i.e. aggregate receivables exceeded aggregate payables, as opposed to the position as at 31 December 1996 when banks had in average the so-called short aggregate exposure to currency risk totalling SIT 18.2 billion. Thus the aggregate exposure to currency risk during the period from 31 December 1996 to 31 December 1997 changed by approximately SIT 25 billion. At the same time aggregate exposure to currency risk on liabilities side reported at end-1996 was shifted to assets side at end-1997.

Figure 16: *Exposure of banks to currency risk as at 31 December 1996*

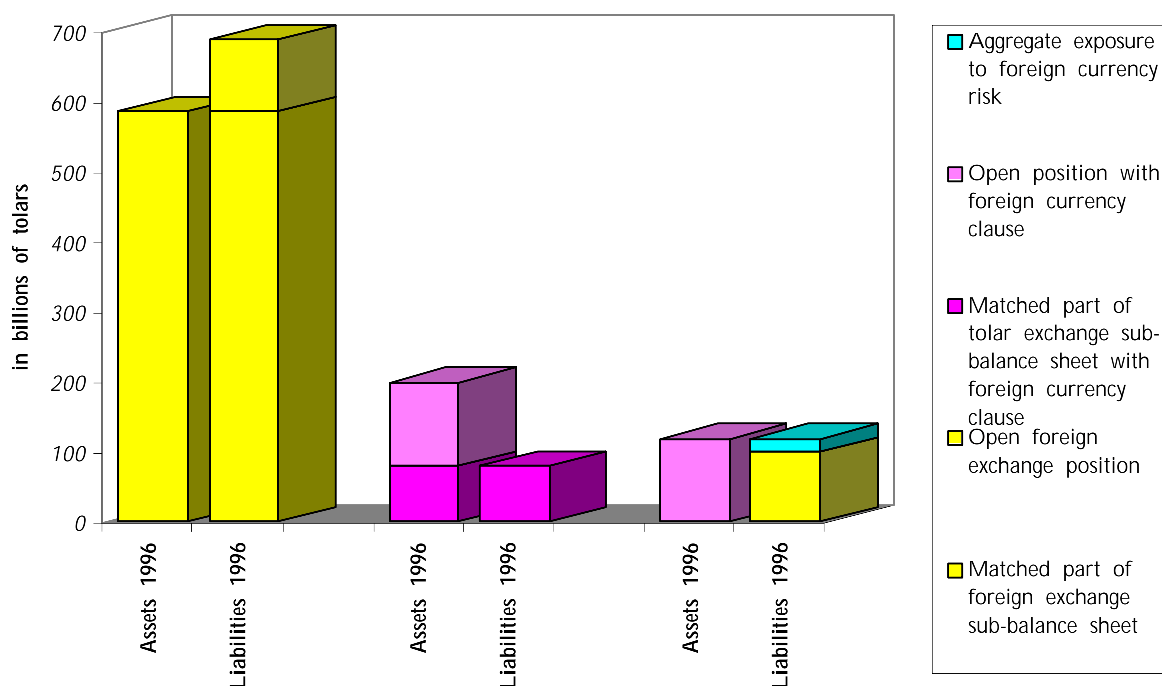
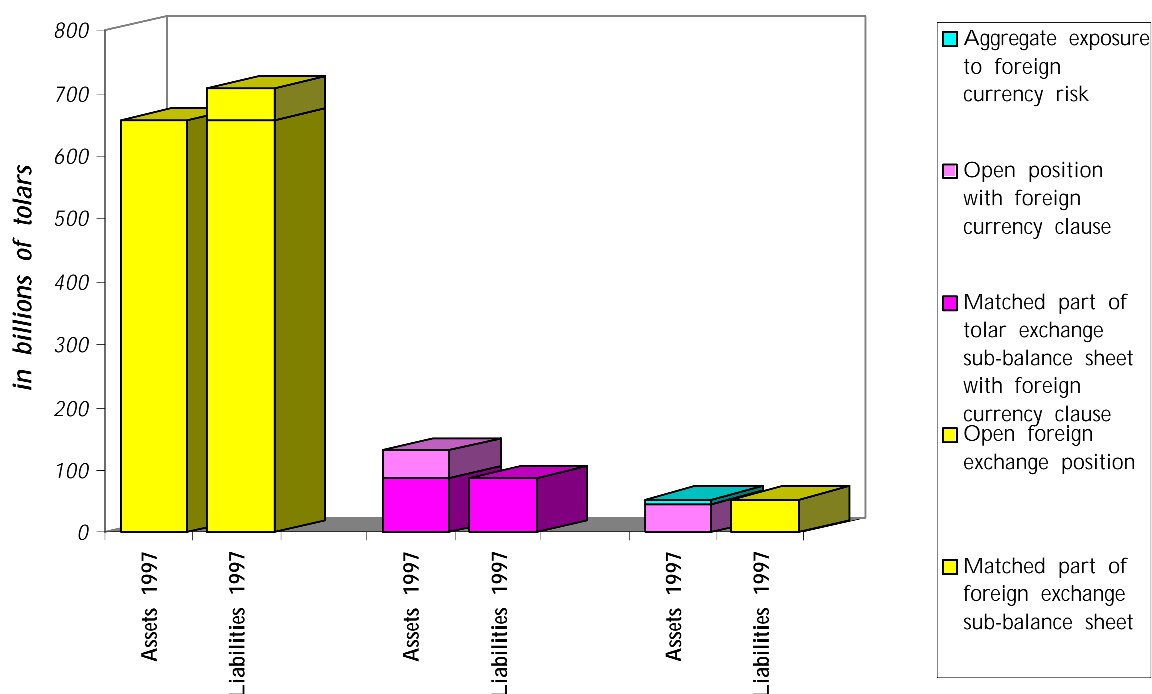


Figure 17: *Exposure of banks to currency risk as at 31 December 1997*



1. *Foreign currency mismatch in savings banks*

As at 31 December 1997, **savings banks** had on their books long foreign exchange position as receivables in foreign currency exceeded liabilities denominated in foreign currency by SIT 19.5 million (savings banks did not have liabilities denominated in foreign currency). The open position of Slovenian savings banks in foreign currency as at 31 December 1997 amounted to 1.8 per cent of regulatory capital.

2. *Mismatch in transactions with foreign currency clause*

Receivables denominated in tolars under contracts with foreign-currency clause exceeded in savings banks as at 31 December 1997 tolar-denominated payables with foreign-currency clause by SIT 51.8 million. These figures reveal long position in items with foreign-currency clause in comparison with the preceding year savings banks had in average short position in items with foreign currency in the amount of SIT 21.5 million.

3. *Aggregate exposure to currency risk*

Aggregate net exposure to possible movements in exchange rates to affect savings banks from 31 December 1996 to 31 December 1997 increased by approximately SIT 63 million, or by 729 per cent, thus totalling SIT 71 million at end-1997. Such steep increase in exposure is due to taking new deposits from banks and savings banks, but also from customers other than banks. The situation is regarded as a short aggregate exposure to currency risk.

2.14. Information technology risk

2.14.1. Bracing up for the year 2000

The difficulties looming with the year 2000 shall be regarded as a global problem likely to affect all branches of industry. It spills across state borders, it has a strong impact on both public and private sector, and it extorts massive financial resources if the »bug« is to be placed under control. Consequences expected to hit the business world appear to be unpredictable and almost impossible to assess.

The word commonly used in association with the year 2000 is "crisis", and all those who have anything to do with information technology (IT) are aware of the problem, while IT experts have been trying to come up with a solution for some ten years. The ticking of the clock has undoubtedly stepped up the efforts, and comprehensive plans are being designed to complete substantially all system conversions by the end of the millennium.

Efforts made to assure that operating and processing systems continue to function when the year 2000 arrives have to be heavily funded, and costs soar as no uniform solution can be provided to different countries, and different institutional and corporate entities.

2.14.1.1. IT strategy within the framework of preparations for the year 2000

The Bank Supervision Department of the Bank of Slovenia started activities related to the year 2000 and supervision of banking operations early enough. Information is passed on to banks and savings banks and recommendations are made as to how to make the necessary conversion and ensure that operating and processing systems continue to function when the year 2000 does arrive.

The strategy and the plan for the implementation of controls were designed in 1996 and have been used since then.

The main goals and key elements of the strategy may be summarised as follows:

- To set up control and examination of the banking sector in Slovenia - readiness being the bottomline,
- To link internal control and IT management with the banking supervision- internal communication being the bottomline,
- Keep the public informed of the progress made by banks and thus cement public confidence in the banking system,
- Implement early warning system - IT system as a mainstay of supervision being the bottomline,
- Building awareness and accountability of all key-players across industry,
- Encourage knowledge transfer, testing, implementation of control mechanism in business processes, etc. - information culture being the bottomline.

Plans and progress of financial institutions are broadly in line with the industry norm

as far as issues associated with the year 2000 are concerned. Most examined banks and savings banks have been issued warnings regarding exposure to IT-related risk, and the preparations for the Millennium are included. Surveys have been planned for the second half of 1998, while during 1999 quarterly reports will disclose compliance with the IT developments in banks with the aim to be able to judge any supervisory risk and decide what kind of response would be appropriate under the circumstances.

2.14.1.2. Core IT-related activities in banks and savings banks

Core IT-related activities have been broadly classified as set forth below. Banks and savings banks have put in place their own plans for the year 2000:

a) Information system control,
b) Activity plan (time available, listing hardware/software facilities, costs, priorities, know-how),
c) Testing modified systems and related facilities,
d) Assessment of preparedness (uninterrupted/continuous business plan),
e) Report on preparedness.

2.14.1.3. Current situation in banking sector

The current situation in the banking sector may be described as the phase of full awareness of the Millennium problem and preparations to face the year 2000. In most Slovenian banks project associated with the year 2000 are well under way. Banks and savings banks which still use old applications, incompatible hardware, or outsource IT services, are faced with even more threatening problem. Key importance is to be assigned to cross-testing of modified software, and testing of interfaced devices. Conversion will be necessary also for records kept in archives. Foreign-supplied software has been or will be replaced by a functioning version which will also be compatible with the year 2000 and in line with respective plans implemented abroad (to be overtaken by the banking sector in the country).

The bulk of responsibility rests with management of banks and savings banks, heads of IT organisational units and heads of internal audit (unfortunately, not all banks have a developed internal audit function also for IT area). The complexity of the issue calls for all players in the business community in the home country to give their best to promote the concept of conversion and the awareness of the need for team playing. The sense of commitment to meet the conversion criterion is widespread among Slovenian banks and savings banks, and although no dates are mentioned, the deadline is on everybody's mind.

Banking supervisors continue to keep watch on all statements made by banks' chief executors and senior management that computer and information systems are or will be ready for the year 2000 on the date designated as the break date (validity date). In the light of the potential supervisory risk should the banks' plans falter, the Bank Supervision Department can resort to the following: control of compatibility and functioning, more intensive communication, checking results of modification testing and benchmarking conversion data, recommending on-duty service to avoid being stuck without qualified staff as the turn of the Millennium will be festive, and disseminating

information to banking supervision/IT control.

An application package to be integrated into the early warning system has been selected. Thus all internal audit functions of banks and IT management teams will be connected to IT supervision within the Bank Supervision Department of central bank.

3. DEVELOPMENTS IN THE LEGISLATIVE FRAMEWORK AND THE PAYMENT SYSTEMS REFORM

Current Slovenian banking legislation is based on acts promulgated upon the proclamation of independence of the Republic of Slovenia. As the banking landscape has been changing fast in the home country and across the border, and as Slovenia is harmonising its legislative framework to international criteria and standards in general, and particularly to acquis communautaire, new banking legislation is to be put in place shortly. The fundamental act to govern the banking sector in Slovenia will be the Banking Law being prepared by the Ministry of Finance in co-operation with the Bank of Slovenia. Secondary banking legislation will be drawn up by the Bank of Slovenia on the basis of stipulations laid down in the Banking Law.

The pending bill of the Banking Law was submitted to Parliament for the so-called first reading in April 1998, while the second reading is scheduled for December 1998. The new Banking Law means a significant step towards full alignment with the EU legislation.

The new law to regulate banking sector in Slovenia will set forth provisions, just as the effective Law on Banks and Savings Banks has done, with regard to establishing banks and savings banks, operating activities and banking supervision. In addition, it will regulate setting up branches of foreign banks, as well as their scope of activities and supervisory arrangements for foreign branches. The new Banking Law introduces principles of consolidated supervision, while the effective deposit insurance scheme will be remodelled. Bankruptcy and liquidation at present dealt with in a seperate law (the Law on Pre-rehabilitation, Rehabilitation, Bankruptcy and Liquidation of Banks and Savings Banks (Official Gazette of the Republic of Slovenia/I, Nos. 1/91, 46/93) will be included in the new Banking Law. The awareness of fast-growing internationalisation and sophistication of banking and financial instruments is distilled in elaborate provisions laying down the framework for closer co-operation between supervisory authorities.

3.1. Secondary legislation regulating supervising of banks and savings banks

During the period under review, the Bank of Slovenia issued several by-laws in the field of banking supervision. In the beginning of 1997, a new Decree on the Classification of On- and Off-Balance Sheet Items of Banks and Savings Bank came into force, imposing more stringent criteria for classifying receivables as the weight of lien on property pledged as collateral was reduced, and special provisions for country risk became mandatory. The Decree was amended in July 1998 by adding a list of special cases which do not call for special provisions for country risk. To facilitate the implementation of the said Decree, the Bank of Slovenia issued in January 1997 two sets of instructions for better understanding of classifying on- and off - balance sheet items and for restructuring non-performing assets.

In May 1997, provisions of the Instructions for the Implementation of the Decree on the Classification of On- and Off-balance Sheet Items in Banks and Savings Banks pertaining to credit insurance provided by Slovene Export Corporation underwent minor changes. In July 1998 provisions regarding exceptional cases in creating value

adjustments and provisions for country risk were amended at the same time as the framework document for issuing the said Instructions – the Decree on the Classification of On- and Off-Balance Sheet Items of Banks and Savings Banks.

In February and later in May 1997, the Decree on Conditions and Criteria for Granting Licences to Banks was amended, resulting in vesting only banks with full licence[37] with the right to open accounts and manage funds deposited by foreign persons, and to keep custody accounts of foreign persons.

The Decree on the Chart of Accounts for Banks and Savings Banks, and the Decree on Financial Statements of Banks and Savings Banks, as well as the Instructions for the Implementation of the Decree on Financial Statements of Banks and Savings Banks were amended several times in the course of 1997 and the first half of 1998. The implementation of mandatory custody accounts for foreign persons called for amending in February 1997 the Decree on the Chart of Accounts for Banks and Savings Banks and the Instructions for the Implementation of the Decree on Financial Statements of Banks and Savings Banks. In November 1997, all three by-laws dealing with accounting practice were substantially modified and made more comprehensive. New accounts were added to the Chart of Accounts, redundant accounts were deleted, and inappropriate account names were changed. One of the main reasons to amend and modify the Chart of Accounts for Banks and Savings Banks has been the acute need to divide individual accounts for banks and financial institutions in compliance with requirements set forth by international statistics. A part of the changes to the Chart of Accounts dealt with amending account codes with three figures to four-figure analytical accounts. Furthermore, new accounts for recording separate transactions were implemented. Modifications and amendments to the Chart of Accounts have been reflected also on partly changed balance sheet format, and the profit and loss account of banks and savings banks in effect from 31 December 1997. In April 1998, accounting standards prescribed for banks and savings banks were enlarged by including settlement accounts with the central bank, and transaction accounts with banks in the home country.

In April 1997, the Instructions for Calculation of Most Common Deposit and Lending Interest Rates, and the Recommendations for Trading Activities in Banks, came into effect. The Recommendations for Trading define responsibility of the management, qualifications required for traders and code of conduct, risk control and risk management, setting up trading business, internal contol systems and audit, handling of special kinds of transactions, etc.

In order to set the framework for consolidated reporting arising from the formation of banking groups, the Bank of Slovenia issued in May 1997 the Instructions for Preparation of Reports on Operations of Banking Groups. It is envisaged that twice a year the leading bank shall submit to the central bank consolidated balance sheet and profit and loss account for the banking group, computation of regulatory capital and capital adequacy for the banking group, as well as the report on the classification of on- and off-balance-sheet items for the banking group.

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[37] Full or unlimited licence under the Slovenian banking legislation means that the bank has at least SIT 4,080 million of regulatory capital.

In May 1997, minor amendments to the Decree on the Method for Calculation of Capital Adequacy for Banks,[38] and the Instructions for Implementation of the Decree on the Method for Calculation of Capital Adequacy for Banks, and amendments to the Decree on the Amount of Provisions and the method of Calculation of Provisions to Protect Banks and Savings Banks Against Potential Losses,[39] were passed. The latter was further modified and amended in January 1998 due to modifications and amendment to the Chart of Accounts, and in July 1998 when a decision stipulating that all banks shall made general provisions not later than 31 December 2000, irrespective of capital adequacy level.

The Decree on Granting Special Liquidity Loans in collaboration with banks was passed in May 1997 replacing a similar decree dating back to July 1996, and enabling banks faced with liquidity problems to take liquidity loans repayable within 9 months, and under the Decree dated May 1997 repayable within one year, from another banks against pledging gilt-edged securities or waiving A-grade receivable to act as security. In May 1998, minor changes were added.

Striving to preserve the overall liquidity of banks and savings banks, the Bank of Slovenia constantly upgrades the requirements imposed on banks and savings banks to maintain the appropriate maturity structure of their assets and to adjust them to the maturity structure of their liabilities. Therefore, in July 1996, the Bank of Slovenia issued the Decree on the Required Adjustments of the Maturity Structure between Assets and Liabilities. The Decree laid down three classes of assets with the determined maturity structure for each class and also prescribed the ratio between the amount of assets with respect to the amount of liabilities in the light of the respective maturity structure. In July 1997, the Decree on the Required Adjustments of the Maturity Structure between Assets and Liabilities was amended to classify as second class assets also loans and securities with outstanding maturity of up to 30 days. New conditions include a clause stipulating classification criteria for banking groups. The Instructions for Preparation of Reports on Effective Proportion between Assets Classified as First, Second and Third Class were also amended in July 1997. More amendments followed in January 1998 to accommodate changes incorporated in the Chart of Accounts for Banks and Savings Banks.

Amendments to Instructions for Preparation of Reports on Major Depositors were enacted in September 1997.

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[38] The Decree was amended pursuant to the decision not to decrease regulatory capital for the amounts of receivables and potential liabilities collateralised with shares of other banks.

[39] Due to the incorporation into the Decree on the Classification of On- and Off-Balance Sheet Items in Banks and Savings Banks of the stipulation making provisions for country risk mandatory, this Decree had to be amended accordingly.

3.2. Deposit guarantee scheme

The Bank of Slovenia carries out insurance operations in banks and savings banks on behalf of and for the account of the Republic of Slovenia in accordance with the Law on the Agency of the Republic of Slovenia for the Insurance of Deposits in Banks and Savings Banks (hereinafter: the Law on Deposit Insurance). In the case of bankruptcy of a bank or a savings bank, the Bank of Slovenia shall repay insured deposits, and thus indirectly guarantees for those deposits. Disbursements are effected directly by the bank or savings bank which has taken over savings operations of the bankrupt bank or savings bank.

In addition to the Law on Deposit Insurance, the issue of insurance of deposits entrusted to banks and savings banks - deposit guarantee scheme - is dealt with also in the Law on Banks and Savings Banks (Article 78), and in the Law on the Bank of Slovenia (Article 99). The nature of the issue called for respective provisions to be incorporated also in the Law on Foreign Exchange Operations (Article 98). Provisions laid down in Article 19 of the Constitutional Law promulgated in the year 1991, provide the mainstay for the maintenance of depositors' confidence in banks. Thus the Constitutional Law laid down foundations for the legislative framework allowing for uncapped guarantee for deposits. Thus the Republic of Slovenia has assumed surety for the payment of all savings deposits denominated in tolars and foreign currency kept in banks and savings banks authorised by the Bank of Slovenia for deposit-taking operations.

Hence the surety provided by the Republic of Slovenia applies to all kinds of savings of private individuals in tolars and in foreign currency, both demand and time deposits, deposits repayable upon notice, or deposit accounts which do not require any notice to be given. The same is valid for current accounts and pass-books issued in the registered name or on bearer, being identification document in which all monies paid in and all withdrawals are entered. The surety of the Republic of Slovenia does not cover either funds in giro accounts of private individuals, or funds deposited on underwriting different kinds of securities, such as treasury bills issued by the bank.

After the enactment of the new Banking Law, the issue of deposit insurance will be set up differently. The disbursement of deposits protected under law to natural and legal entities will be guaranteed up to the amount fixed by the respective law on the day the bankruptcy proceedings are instituted.

3.3. Payment Systems Reform

Payment systems in the early nineties stayed on the same track despite substantive changes in a number of areas. The payment systems were functioning under the umbrella of the Agency for Payments (APP), as the residue of the monobanking system which in the early sixties was transformed into two-tier banking system. The Agency for Payments was maintaining giro accounts of legal persons - customers of commercial banks, accounts of commercial banks (including accounts for mandatory reserves), and also the account of the Bank of Slovenia. Under such payment systems, the Agency for Payments was the only provider of payment services, and balances in

the accounts of legal persons were at the end of the business day integrated into the accounts of commercial banks held with the Agency for Payments. Such a system has never provided settlement in real time. Furthermore, it has never equipped banks with adequate tools to effectively manage liquidity and credit risk. On the other hand, such a payment system hindered the central bank in its efforts to get an insight into the systemic risk and base money creation.

In line with respective decisions of competent governmental bodies, the reform was launched with the aim to shift the payment systems to commercial banks and the central bank. Thus the comparability between the local payment systems and the systems functioning in developed market economies will be achieved. The implementation of the new payment systems does not fall into the province of work of the Bank of Slovenia only, although the central bank is indeed in charge of the migration project and the designing of the new payment systems. Under the new system, accounts of legal persons will be maintained by the banks, while the accounts of banks will be held with the Bank of Slovenia, but the complexity of the issue and the scope of responsibility call for co-ordinated activities of the Bank of Slovenia, Ministry of Finance, Agency for Payments, commercial banks, and the Statistical Office of the Republic of Slovenia.

3.3.1. The outline of the payment systems reform

The reform of the payment systems has been launched with the ambition to fulfil the goals listed below:
- gross settlement in real time (abbreviation in Slovene: BPR^) for large and urgent payments,
- payment system for small values (abbreviation in Slovene: SPMV) / integral clearing system,
- various forms of payments through electronic payment systems.

The implementation consists of six phases:

1. 1st phase: The transfer of mandatory reserves accounts of banks, savings banks and savings co-operatives from the Agency for Payments to the Bank of Slovenia.

2. 2nd phase: The implementation of the real-time gross settlement system for interbank transactions.; opening of settlement accounts of banks and some savings banks with the Bank of Slovenia, opening of transactional accounts for indirect participants to the real-time gross settlement system with direct participants.

3. 3rd phase: Banks phase-in the provision of payment transactions for their own customers.

4. 4th phase: Having overtaken payment transactions for all their customers, banks close their accounts with the Agency for Payments.

5. 5th phase: Branches of the Agency for Payments without customers to serve are wound up.

6. 6th phase: All banks carry out payment operations for their customers, hence the Agency for Payments will be abolished.

The 1st phase of the payment systems reform (mandatory reserve accounts of the banks, savings banks, and savings co-operatives were transferred from the Agency for Payments to the Bank of Slovenia in March 1997), as well as the 2nd phase (real-time gross settlement system was implemented in April 1998 - at first only for pure interbank transactions, later also for all high value and urgent transactions), were implemented according to the time scheduled.

The Agency for Payments still maintains accounts of legal persons (account balances are integrated with respective banks' accounts after final processing in the Agency for Payments). During the transition period, the Agency for Payments also maintains the so-called positions 620 and 625 of those commercial banks and savings banks which hold settlement account with the Bank of Slovenia). The information system set up along with the real-time gross settlement system (BPR^) enables direct participants to be informed practically without delay of the balance with the Agency for Payments and the balance in the settlement account with the Bank of Slovenia. Timely, updated information improves liquidity management, and hence, the soundness of the whole banking system.

Only banks and savings banks have direct access to the real-time gross settlement system, whilst the Integral Small Value Payment System (ISVPS) / integral clearing will be made available to all users within the framework of the future corporation for Slovenian Payment Company (Slovene abbreviation: DOPS).

3.3.2. Integral small value payment system (ISVPS)/ integral clearing system

Stages of the payment systems reform designated as phases 3 to 6 envisage gradual transfer of legal persons' accounts to commercial banks, and eventual winding-up of the activities of the Agency for Payments in its capacity of the provider of payment services.

The implementation of these phases is directly linked with setting-up a system to process payments of small amounts. The Bank of Slovenia has tested the system, and in October 1998 operations using the so-called giro clearing commenced. Giro clearing system is a pilot version of the future integral clearing of non-urgent payments of small amounts.

The integral clearing system will comprise a wide spectrum of payment services in line with the commitment to keep abreast of developments in modern business community, hence banks will be equipped to take over also the remaining payment system functions currently executed by the Agency for Payments. The time required for setting up the integral clearing system and for the completion of the project is estimated to be between 18 and 24 months. Thus the completion of the payment systems reform is scheduled in the year 2001.

3.3.3. Reform of cash operations

The concept of the migration of cash payment transactions in banking environment deals with direct and indirect supply of banks with banknotes, as well as the transfer

of payments and disbursements from the Agency for Payments to banks.

The supply of banks with banknotes will be based on vaults managed by authorised banks. During the initial stage of operations, vaults will be set up in 8 places: Ljubljana, Celje, Koper, Kranj, Nova Gorica, Novo Mesto, Maribor, Murska Sobota. The time will show if this number should be increased or decreased in the light of both needs and available resources. Bank money supply from regional vaults is expected to be fully operational in June 1999.

Payments and disbursements effected by legal persons will be moved into the banking environment under the new cash payment systems. Test phase for cash transactions of legal persons carried out by banks commenced on 1 October 1998 and is scheduled to last until 31 December 1998. The pre-commissioning encompasses 7 banks with 195 legal persons.

Supplying banks with coins will be organised separately from the banknote supply. Due to mainstreaming operations and cutting costs, banks will be able to obtain coins from one place equipped for wholesale coin distribution.

3.3.4. Decision

Phases 3 - 6 will be phased in over the forthcoming 24 months, whilst the pace of introducing changes will depend on the Ministry of Finance which is responsible for drafting necessary legislation. The milestones for the execution of the project have been made both for project phases and for the entire project of the payment systems reform, and are subject to modifications.

The underlying tone running through all phases described above, is the need to define and implement the adopted strategy for the transformation of the role of the Agency for Payments in the reformed payment systems environment.

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