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Tel: +386 1 4719000
Fax: +386 1 2515516

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Abbreviations:

AJPES	Agency of the Republic of Slovenia for Public Legal Records and Related Services
SMA	Securities Market Agency
ISA	Insurance Supervision Agency
GDP	Gross domestic product
BLS	Bank Lending Survey
BRIC	Brazil, Russia, India, China
BoS	Bank of Slovenia
CRR	Capital Requirements Regulation
CRD IV	Capital Requirements Directive IV
OFIs	Other financial institutions
DSTI	Debt service-to-income ratio
TARS	Tax Administration of the Republic of Slovenia
BAMC	Bank Asset Management Company
DSs	Debt securities
AMC	Asset management company
ECB	European Central Bank
EIOPA	European Insurance and Occupational Pensions Authority
EMU	Economic and Monetary Union
EONIA	Euro OverNight Index Average (weighted average interest rate for overnight credit)
EU	European Union
EURIBOR	Interbank interest rate at which representative banks in the euro area offer deposits to one another

Eurostat	Statistical Office of the European Communities
EU-SILC	European Union Statistics on Income and Living Conditions
Fed	Board of Governors of the Federal Reserve System
SMARS	Surveying and Mapping Authority of the Republic of Slovenia
HICP	Harmonised Index of Consumer Prices
IFs	Investment funds
KDD	Central Securities Clearing Corporation
TR	Turnover ratio
Leaseurope	European Federation of Leasing Company Associations
LJSE	Ljubljana Stock Exchange
LTRO	Long-Term Refinancing Operation
LTV	Loan-to-value ratio
MCR	Minimum capital requirement
IMF	International Monetary Fund
SMEs	Small and medium-sized enterprises
MTS Slovenia	Part of the Euro MTS electronic trading platform for euro-denominated government and para-government benchmark bonds
NFCs	Non-financial corporations
QE	Quantitative easing
ROE	Return on equity
SBI TOP	Blue-chip index at Ljubljana Stock Exchange
SCR	Solvency capital requirement
SDW	Statistical Data Warehouse
Slonep	Slovenian real estate portal (www.slonep.net)
SURS	Statistical Office of the Republic of Slovenia
S&P	Standard and Poor’s
TLTRO	Targeted Longer-Term Refinancing Operation
AUP	Average unit price of a mutual fund
VLTRO	Very Long-Term Refinancing Operation
MF	Mutual fund

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

EXECUTIVE SUMMARY

The stabilisation of the macroeconomic environment and the forecasts of continuing GDP growth in the coming years is having a beneficial impact on the financial position of business entities and households. The recovery of the real estate market is strengthening the portion of demand that banks are ready to support to a greater extent with loans, and could contribute to economic growth in various sectors. In such an environment the greatest risks to the banking sector come from the low interest rate environment, which sets banks the challenges of income generation and exposure to interest rate risk. The corporate sector is stronger than a few years ago, and is also less dependent on bank financing. For banks there remains the risk related to the amount of new financially stable debtors, and the problem of attracting new business. This has been reflected in the slow decline in the proportion of non-performing loans in the banks' portfolio, despite the increasingly active resolution of this segment of the portfolio.

The evolution of income risk and interest rate risk and the ability to generate new capital and to maintain a stable capital position also depend on the banks' ability to generate income in the low interest rate environment.

Table 1: Overview of risks in the Slovenian banking system

Systemic risk	Risk assessment for Q2 2016	for Q3 2016	for Q4 2016	Trend in risk	Commentary
Macroeconomic risk				→	Economic growth remains relatively high. In addition to exports, private consumption is gradually strengthening, but investment activity remains weak. Macroeconomic risks are assessed as low and balanced. The largest risk to continued growth comes from the external environment.
Credit risk				→	The positive trend of decline in claims more than 90 days in arrears is continuing, partly as a result of the ongoing sale of the banks' bad portfolio in the third quarter. Coverage by impairments and collateral is continuing to increase. The quality of the SMEs portfolio is also improving, but nevertheless remains weaker than other segments of the banking system's portfolio.
Real estate market				→	The real estate market is undergoing a stable recovery, with moderate growth in prices of residential real estate and an increase in volume. Over longer horizons, there is a possibility of increased risks in the real estate market, in the event of faster growth in prices or in the volume of transactions in real estate.
Refinancing risk				→	An increase in the proportion of bank funding accounted for by deposits by the non-banking sector, and a simultaneous decline in their average maturity. A decline in coverage of sight deposits by liquid assets, albeit in the context of high secondary liquidity.
Interest rate risk				↑	Interest rate risk remains at a high level. The difference between the average repricing periods for asset and liability interest rates is continuing to widen. The proportion of loans with a fixed interest rate is increasing.
Contagion risk and large exposure				→	Contagion risk remains low, as liabilities between banks decline. The amount of capital required to restore the original capital ratios after any contagion is also declining. Concentration risk remains significant from the perspective of the proportion of the banks' total assets accounted for by government securities.
Solvency risk				↑	Capital adequacy is continuing to increase, and is being maintained at an appropriate level across the banking system. The small domestic banks remain the most vulnerable in capital terms. The low interest rate environment means that the stability of capital adequacy could remain subject to the limited ability to generate internal capital.
Income risk				↑	Low impairments and provisioning are currently bringing a strong improvement in the banks' income position. The persistent negative growth in net interest income is increasing the banks' income risk in the future.

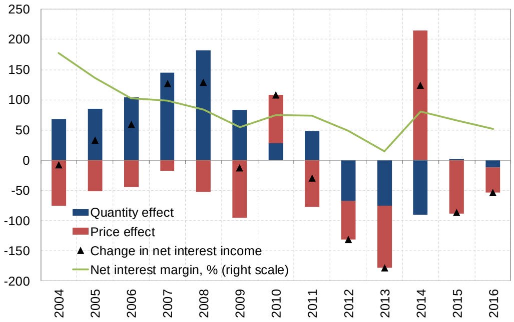
Colour code:

Source: Bank of Slovenia

The banks' performance improved in 2016, primarily as a result of a reduction in credit risk and lower impairment costs, and the one-off impact of increased non-interest income. The main constraints on income generation remain the contraction in turnover and the fall in interest rates. Net interest income, which accounts for approximately two-thirds of the banks' gross income, is continuing to decline, and the banks are unlikely to maintain the current level of profitability in the future.

The improvement in performance through growth in non-interest income was more attributable to one-off factors in 2016, and not to changes in the banks' business models. In recent years net interest income was under the prevailing influence of price factors, and less under the influence of quantity factors, despite the contraction in bank turnover. As a result of the faster fall in asset interest rates over the last two years, the price factors on the asset side of the balance sheet have prevailed over the effects on the liability side, which are already losing their impact owing to the low levels of deposit rates reached. Further shortening of the average maturity of deposits would not have a major beneficial impact on the banks' income.

Figure 1: Contribution to change in net interest income made by quantity and price factors, in EUR million, and net interest margin, in percentages



Source: Bank of Slovenia

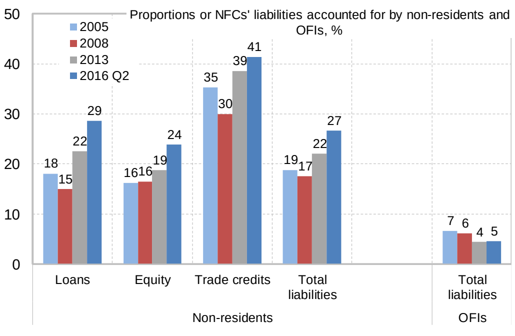
Under these conditions it is only possible to maintain or increase net interest income by increasing quantity factors, i.e. turnover or the amount of lending. According to Bank of Slovenia forecasts, an increase in loans to the non-banking sector will not be achieved until 2018. The maturing of relatively high-yielding securities over the next two years will see the loss of another major source of interest income.

The increase in the quality of bank investments is having a beneficial impact on the banks' income via a decline in impairment costs. In light of the high coverage of non-performing claims by impairments achieved, the further reduction in credit risk and the continuing favourable macroeconomic developments, impairment costs can be expected to have a positive impact on income generated. However, impairment costs are pro-cyclical in nature, and do not necessarily have a long-term positive impact on the banks' income generation.

Bank lending to corporates cannot be expected to return to its average of the pre-crisis years any time soon. The structure of the Slovenian economy has changed since the outbreak of the financial crisis. Construction, which made a significant contribution to economic growth in the pre-crisis period, and was financed primarily by domestic banks, has declined sharply as a proportion of value-added. The banks are significantly less exposed to construction and to financial holding companies than in the past, as a result of numerous and large-scale corporate bankruptcies and the contraction in these sectors. Firms that finance themselves outside the Slovenian banking system are also becoming more important in the manufacturing and service sectors.

The healthy part of the economy, the part that is contributing most toward economic growth, changed the structure of its financing in previous years, with greater reliance on internal resources and on financing in the rest of the world. The proportion of total corporate financial liabilities accounted for by non-residents reached 27%, compared with 17% in 2008.

Figure 2: Proportion of individual types of corporate financing accounted for by non-residents, in percentages



Source: Bank of Slovenia

Firms under majority foreign ownership, which largely rely on direct or indirect financing from their (new) owners, are increasing their financing in the rest of the world. The domestic banking system is thus losing a specific part of its financially stronger and more creditworthy demand.

The revival of corporate investment activity could be supported by financing at domestic banks. The latest figures for demand for loans reveal a qualitative shift in the breakdown of corporate demand, with a decline in the proportion of loans for restructuring purposes and an increase in demand for loans for investment, which is being reported by the majority of banks and savings banks in Slovenia.

A high level of excess corporate demand has been maintained, partly as a result of the banks' tightened credit standards, although to a significant extent it is a reflection of the refusal of loans by firms who judge that they could obtain their financing elsewhere at more favourable terms. If the changing structure of the economy is an external factor over which the banks have no major influence, adjusting to the needs of creditworthy clients has become a necessity that derives from the challenges of the low interest rate environment and requires the careful weighting of risks and returns in individual investment segments. If the banks wish to increase income over the long term, they will have to significantly improve the effectiveness of their risk management, and to be able to take up risks in new business and new sectors.

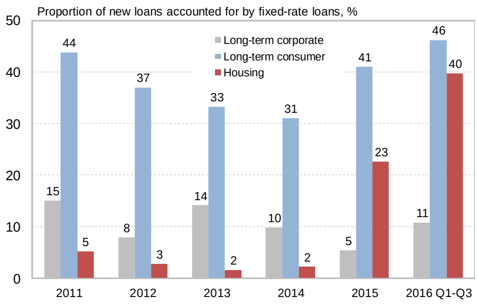
The banks are seeing a gradual reduction in credit risk. Given their high coverage of non-performing claims by impairments, and their high capital adequacy, the banks are relatively well-protected in the event of a major deterioration in portfolio quality. The banking system's capital is five times the stock of claims more than 90 days in arrears not covered by impairments, an incomparably higher figure than a few years ago. Capital adequacy improved again in the first half of 2016, primarily as a result of a further decline in capital requirements, and to a lesser extent as a result of a further increase in capital. Despite the favourable capital adequacy at system level, individual banks could face a capital shortfall in adverse circumstances. The retention of earnings in capital is therefore important, if there is no guarantee of meeting the prudential requirements over the upcoming medium term of two to three years, having regard for the upcoming regulatory requirements (IFRS 9, MREL).

The banks' focus on domestic funding is reducing their dependence on the wholesale financial markets, but at the same time the low interest rate environment is introducing instability into this structure. Sight deposits now account for 41% of total liabilities, and the figure is expected to increase further. The risk of instability in deposits is mainly present in highly volatile deposits by corporates, which have recently faced additional costs in maintaining sight deposits in accounts at certain banks, and which began to stagnate in 2016 after several years of increase. In a favourable investment environment, corporate deposits, on which the opportunity cost of maintaining the deposits has been low to date, could be withdrawn from the banking system to a certain extent towards new commercial investments, or towards various financial assets or real estate.

The banks' high liquidity and opportunities to obtain additional liquidity from the Eurosystem constitute an important safety valve in bridging any increased liquidity requirements on the part of the banks owing to a widening maturity gap between investments and funding. The banks' liquid investments have reached 10% of total assets, a figure several times higher than a few years ago. The banking system's liquidity risk thus remains at a low level, with favourable primary and secondary liquidity. However, the importance of secondary liquidity could increase rapidly in the event of increased instability in sight deposits triggered by external shocks. A large portion of secondary liquidity at Slovenian banks is held in government securities.

The banks are seeing a further increase in interest rate risk, in the wake of the funding of investments of ever-lengthening maturities with short-term and sight deposits. The gap between the average repricing periods for asset and liability interest rates is widening. On the asset side in particular the lengthening of the average repricing period is also attributable to an increase in the proportion of loans with a fixed interest rate. In the event of a rise in interest rates this will be reflected in a decline in the banks' net interest income.

Figure 3: Proportion of new loans with a fixed interest rate



Source: Bank of Slovenia

The supply of loans with a fixed interest rate is encouraging household borrowing. Household loans have already exceeded corporate loans on bank balance sheets, in terms of net value. After declining for several years, consumer loans also recorded positive growth in 2016, the rate having already matched growth in housing loans.

The real estate market is continuing to undergo a stable recovery, which began in 2015, without any signs of overheating. Residential real estate prices are rising moderately, and the volume of transactions is increasing. Indicators of the sustainability of housing lending at banks are stable, and do not suggest any increased risk to the banking system. The situation on the real estate market is stable, and currently does not represent any direct risk to financial stability, although exposure to systemic risk could increase at the beginning of a new financial cycle. Over longer horizons, there is a possibility of increased risks in the real estate market, in the event of faster growth in prices and in the volume of transactions in real estate. The favourable financing conditions and relatively low real estate prices could encourage greater demand not just from those seeking housing, but also from investors, which could put upward pressure on real estate prices, with potential risk to the banking system. For this reason the Bank of Slovenia introduced two macroprudential instruments in the form of recommendations in September 2016: a maximum limit on LTV and DSTI as macroprudential recommendations for housing loans. The two instruments would become binding in the event of increased risks as a result of a failure to observe the recommendations, while an increase in risks despite the observation of the recommendations would be followed by a tightening of the instruments' parameters.

Because of the poorly developed domestic capital market, shadow banking in Slovenia is also developing more slowly than elsewhere in Europe. The main source of shadow banking in Slovenia consists of money-market and bond investment funds and other financial entities (other than insurance corporations and pension funds), such as leasing companies. The size of the shadow banking sector in Slovenia is estimated at EUR 5.5 billion, or 8% of the financial system's total financial assets. Shadow banking in Slovenia declined in the past, primarily as a result of the contraction in leasing business and the winding-up of numerous financial holding companies in the first five years after the outbreak of the economic crisis.

1 MACROECONOMIC ENVIRONMENT

Summary

Economic growth in the euro area continued in the first half of 2016, at a slightly slower pace. The internal political factors and geopolitical risks remain constraints on future growth, with the uncertainty of the economic consequences of the UK's exit from the EU and the election of a new president in the US to the fore. Despite occasional fluctuations, confidence indicators in the euro area are gradually improving, and inflation is strengthening, although it remains at a relatively low level.

The economic situation in Slovenia is continuing to improve, as is evident in the continuing relatively strong economic growth and in the improvement in the situation on the labour market. In addition to exports, private consumption is gradually strengthening, but investment activity remains weak. Employment growth reached 2% in the first half of the year, the highest rate since the outbreak of the crisis, while the surveyed unemployment rate fell below 8%. The average gross wage is also rising, but households nevertheless remain cautious, and are increasing their saving rate in the low interest rate environment.

Moderate growth in residential real estate price has continued with the increased volume of transactions also in 2016. Demand for housing loans is continuing to rise, and is increasingly being reflected in growth in new housing loans. Housing affordability excluding payment terms has deteriorated slightly, as real estate prices have risen faster than wages. The rise in the number of transactions has not yet been reflected in price rises in the commercial real estate sector.

Firms are gradually increasing their ratio of capital to financial debt by reducing indebtedness. The proportion of foreign capital is increasing, albeit without any increase in corporate capital levels. Internationalisation is bringing an increase in corporate borrowing in the rest of the world. That there is less demand for loans from domestic firms (a contraction in the credit market for domestic lenders) is also attributable to changes in the structure of the economy, where construction is much less important than before the crisis. Construction has accounted for a significant proportion of the firms that have entered bankruptcy since 2009. The firms that went bankrupt entailed a loss of demand for bank loans, which is not likely to be replaced any time soon by demand from new firms.

Corporate investment activity is gradually reviving. Firms are primarily financing themselves by means of internal resources, or a reduction in their positive net financial position, and by means of foreign financing. Slovenian banks are not involved enough in the revival of corporate investment activity: they are losing their position and share on the credit market. Firms that have gone bankrupt, shifts in the structure of the economy, in which manufacturing and services are growing in importance, and the change in the structure of corporate financing with an emphasis on financing from the rest of the world have all entailed a loss of demand for Slovenian banks.

1.1 International environment

Economic growth in the euro area continued in the first half of 2016, at a slightly slower pace. According to the forecasts of international institutions, economic growth in the euro area will be between 1.5% and 1.7% in 2016, with similar rates expected in 2017 and 2018. In the wake of further improvement in the situation on the labour market, the main contribution to economic growth came from private consumption, although gross fixed capital formation and government consumption also contributed to a lesser extent. The contribution made to GDP growth by net exports was slightly negative, but export growth is forecast to begin gradually increasing again next year. The sectors that contributed most to growth were services and industry.

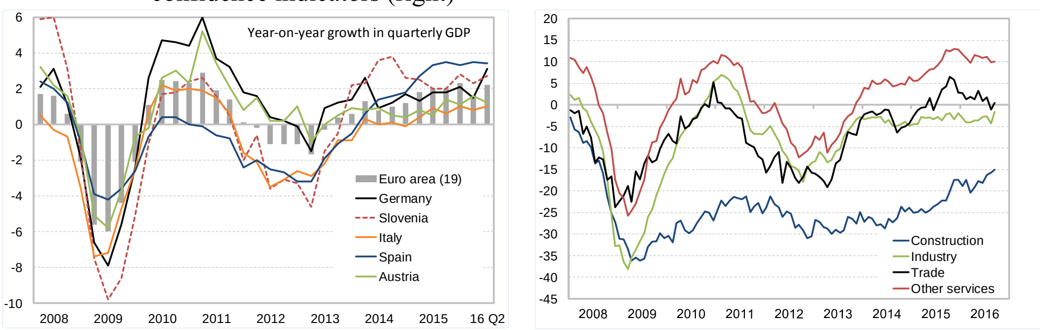
Table 1.1: European Commission forecasts of selected macroeconomic indicators for Slovenia's main trading partners, in percentages

	Real GDP				Employment rate				Inflation			
	2015	2016	2017	2018	2015	2016	2017	2018	2015	2016	2017	2018
EU	2,2	1,8	1,6	1,8	9,4	8,6	8,3	7,9	0,0	0,3	1,6	1,7
Euro area	2,0	1,7	1,5	1,7	10,9	10,1	9,7	9,2	0,0	0,3	1,4	1,4
Germany	1,7	1,9	1,5	1,7	4,6	4,4	4,3	4,2	0,1	0,4	1,5	1,5
Italy	0,7	0,7	0,9	1,0	11,9	11,5	11,4	11,3	0,1	0,0	1,2	1,4
Austria	1,0	1,5	1,6	1,6	5,7	5,9	6,1	6,1	0,8	1,0	1,8	1,6
France	1,3	1,3	1,4	1,7	10,4	10,0	9,9	9,6	0,1	0,3	1,3	1,4
Croatia	1,6	2,6	2,5	2,3	16,3	13,4	11,7	10,3	-0,3	-0,9	0,8	1,5
Slovenia	2,3	2,2	2,6	2,2	9,0	8,4	7,7	7,2	-0,8	0,1	1,5	1,9

Note: Shaded area signifies the European Commission forecasts.
Source: European Commission, autumn forecasts

Economic growth in some of Slovenia's major trading partners will strengthen slightly in 2016, but will remain moderate according to the European Commission's forecasts. High growth is forecast for Croatia, while the forecasts for south-eastern Europe and Russia were also revised upwards. Alongside low inflation, the favourable forecast was attributable to growth in household consumption, although internal and geopolitical risks that entail uncertainty in future growth still prevail in certain countries. Another source of the risk of slower growth is the economic uncertainty surrounding Brexit, although the effects of the exit announcement have been relatively small for the moment. Additional uncertainty has been brought by the election of a new president in the US, particularly with regard to the consequences for trade agreements. At this moment it is still too early to assess the potential impact on the euro area.

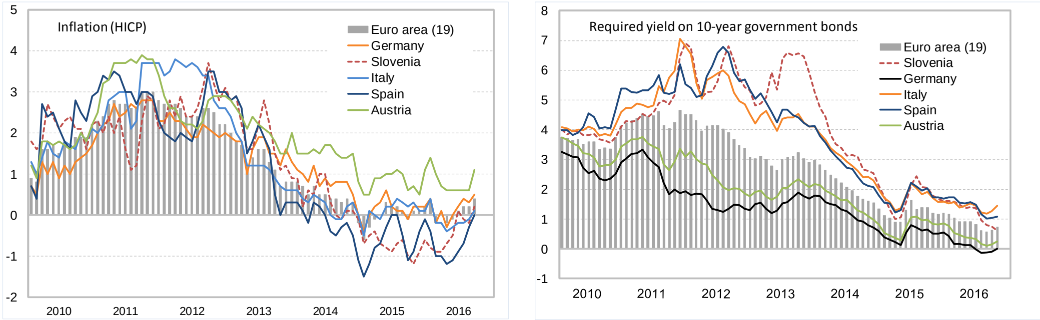
Figure 1.1: Year-on-year growth in quarterly GDP, in percentages (left), and euro area confidence indicators (right)



Note: GDP figures are not seasonally adjusted.
Sources: Eurostat, European Commission

In the wake of continuing moderate economic growth, the economic sentiment has also remained stable. The economic sentiment remained at a similar level in the majority of sectors in 2016, although significant variation from sector to sector remains. The construction confidence indicator remains at a low level, although a continuing positive trend has again been evident in 2016 as a result of an increase in the amount of construction put in place and the positive outlook in the housing market. The largest increases in confidence in recent months were recorded by industry, in the wake of an anticipated increase in orders, and by retail, as a result of the positive expectations in the business environment. Despite a gradual improvement in the confidence indicators there has been significant volatility from month to month, which is indicative of the persistent uncertainty and the merely moderate growth forecasts for the euro area.

Figure 1.2: Year-on-year inflation (left), and required yield on government bonds (right), in percentages



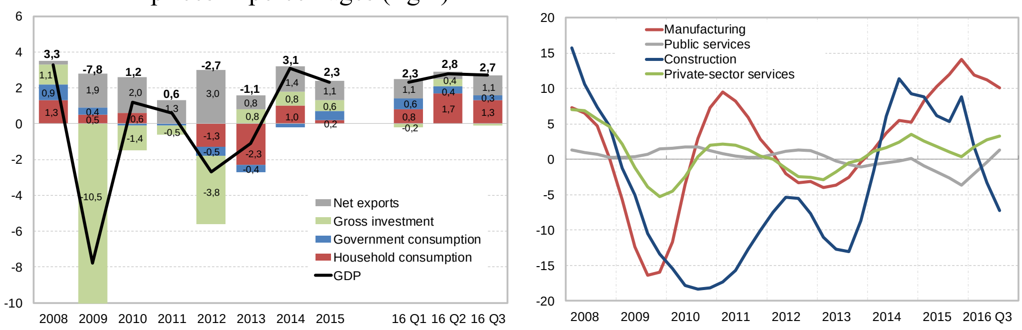
Source: Eurostat

Inflation is also gradually strengthening, but remains at a low level. The main factors in the movement of inflation are prices of energy and other commodities. Most notably, after falling sharply in 2015, oil prices rose slightly over the first half of 2016 and then stabilised. The renewed growth in oil prices was primarily attributable to an agreement between the largest oil producers to freeze pumping quantities. Other commodity prices also began rising in the first half of 2016. Low interest rates will continue to have a positive impact on economic activity and the inflation rate in the future, as a result of the maintenance of monetary stimulus by the ECB. The results of the ECB's non-standard measures are also evident in the required yields on government bonds, which have remained at historically low levels, and have entered negative territory in certain countries.

1.2 Economic developments in Slovenia

Economic growth continued over the first three quarters of the year, and stood at 2.6% in year-on-year terms. A similar rate is forecast for the end of the year, which is again expected to be above the average across the euro area. The difference in economic growth is primarily the result of the different dynamics in industrial production, where growth in Slovenia is strongly outperforming the euro area. Exports remain the main engine of economic growth in Slovenia, and are strengthening as a result of growth in foreign demand and the improved competitiveness of the tradable sector. Domestic private-sector demand is also growing more and more strongly as a result of the improvement in the situation on the labour market and growth in household disposable income. Investment activity remains weak in 2016, as a result of the decline in government investment in the wake of lower disbursement of EU funds during the changeover to the new European financial framework. The good outlook for business and the economy is contributing to further growth in private-sector investment in machinery and equipment. Government consumption can be expected to increase in the future, as a result of a rise in employee compensation and growth in expenditure on goods and services in healthcare.

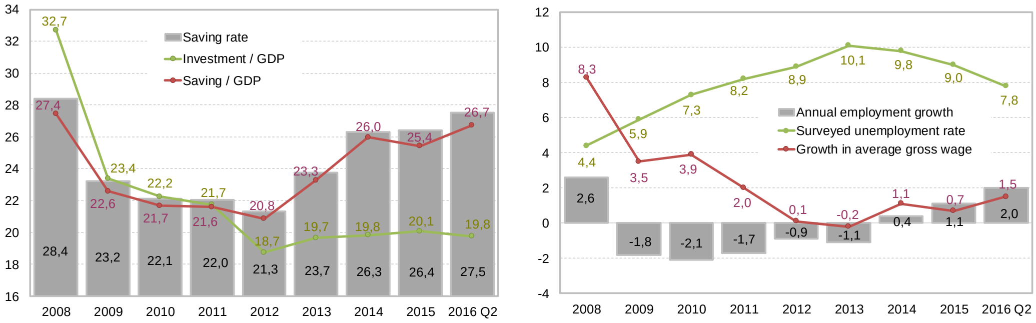
Figure 1.3: Year-on-year growth in GDP in percentages and contributions to GDP growth in percentage points (left), and year-on-year growth in value-added by sector at fixed prices in percentages (right)



Source: SURS

The largest increase in value-added was recorded by manufacturing, while the largest decline was recorded by construction. Value-added increased in the majority of manufacturing industry segments. Employment growth was the main factor in the continuing moderate growth in private-sector services and public services. Despite a year-on-year decline in value-added in construction, there are signs that the situation is stabilising: growth in the amount of construction put in place and the value of new contracts for buildings, and a rise in the number of building permits issued. An increase in value-added is also forecast for the majority of sectors in the next two years, although export-oriented manufacturing will remain the main engine of economic growth.

Figure 1.4: Saving rate, and ratios of investment and saving to GDP (left), and surveyed unemployment rate and year-on-year growth in employment and gross average wage (right), in percentages

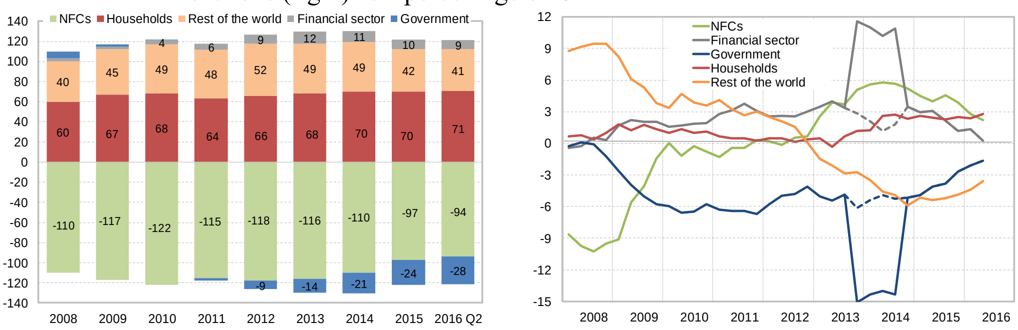


Source: SURS

With the saving rate increasing, the ratio of investment to GDP has continued to decline. Private-sector investment has continued to grow, but there was a sharp decline in government investment in the wake of lower disbursement of EU funds. The widening saving-investment gap is indicative of a continuing reluctance to expand investment activity, as the saving rate is continuing to rise despite very low interest rates. The encouraging conditions for consumption and investment are currently only being reflected in strengthened household consumption. Increased investment can nevertheless be expected in the future in the wake of the revival of the real estate market and the low interest rates. Employment growth and the fall in unemployment below 8% mean that the situation on the labour market is continuing to improve at a faster rate.

Non-financial corporations have remained in the unusual position of net creditors of other sectors in current transactions, although the position has gradually diminished over the last two years. Non-financial corporations' net credit financial position is an indicator of persistent caution in investment and the continuation of deleveraging. Low corporate investment activity despite the favourable economic situation and borrowing costs is a consequence of a lack of equity and limited creditworthiness in obtaining financing from banks. The household and government sectors also remain reluctant to increase consumption. The household sector again moved into a net credit position vis-à-vis other sectors in 2013, but in contrast to non-financial corporations it has not seen this position diminish in 2016, as households further raise their saving rate despite less attractive terms.

Figure 1.5: Net financial position of institutional sectors in terms of stock (left), and annual transactions (right) as a percentage of GDP

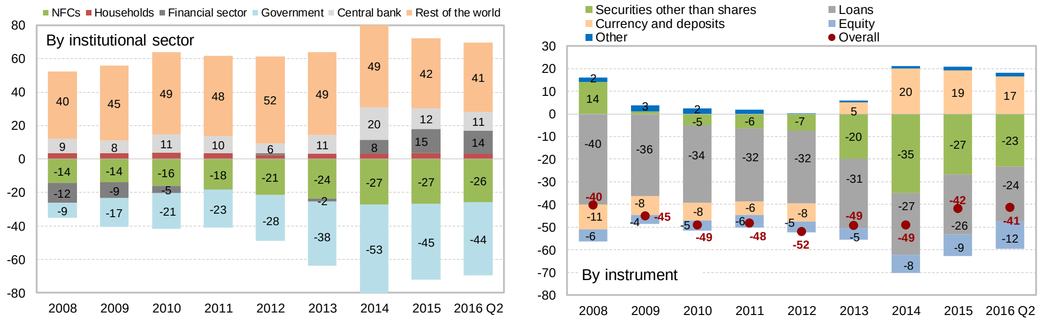


Note: Annual transactions are calculated as four-quarter moving sums. Transactions excluding the effects of the recapitalisations at the end of 2013 are illustrated in dotted lines for the financial sector and the government sector.

Sources: Bank of Slovenia, SURS

The net financial liabilities of the domestic institutional sectors vis-à-vis the rest of the world remain comparable to the previous year at 41% of GDP. All institutional sectors other than households saw a slight decline in exposure to the rest of the world in the first half of the year, a reflection of their continued repayments of debt to the rest of the world. Having increased significantly in previous years, corporate indebtedness in the rest of the world is no longer increasing, but remains at a relatively high level. Despite the recovery and resolution of the domestic banking sector in late 2013, and the improved access to financing at domestic banks, there is no expectation that firms will return to the domestic banking market in the near future. The business relationship between a firm and a bank is usually longer-term, and moreover, firms are relying to a greater extent on non-bank financing.

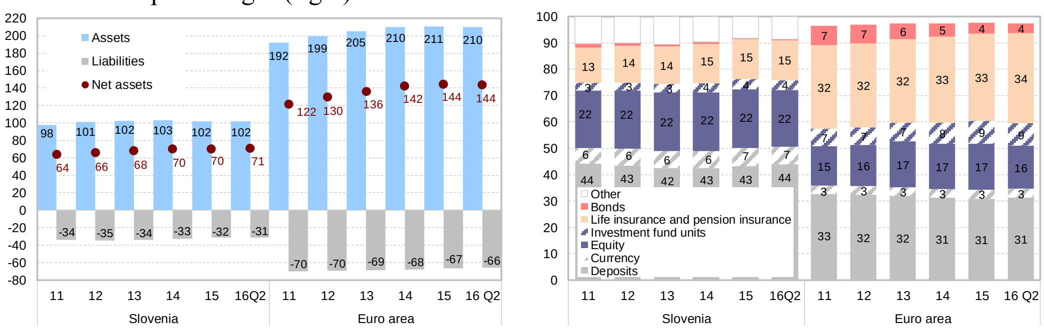
Figure 1.6: Net financial position against the rest of the world by institutional sector (left) and by instrument (right), as a percentage of GDP



Sources: Bank of Slovenia, SURS

Foreign equity increased to 12% of GDP in the first half of 2016, partly as a result of acquisitions in the Slovenian banking system. With the exception of foreign equity, which remains an opportunity for firms to obtain significant source of financing, all instruments saw a decline in their net financial position against the rest of the world. The repayments of debt to the rest of the world by the institutional sectors, most notably the banks, reduced the net debt position in loans, while by contrast the net credit position in deposits increased, which was primarily attributable to an increase in the banks' liquid assets. Compared with 2014 there has been a significant decline in indebtedness to the rest of the world in the form of debt securities, partly as a result of reduced borrowing requirements on the part of the government and the financial sector.

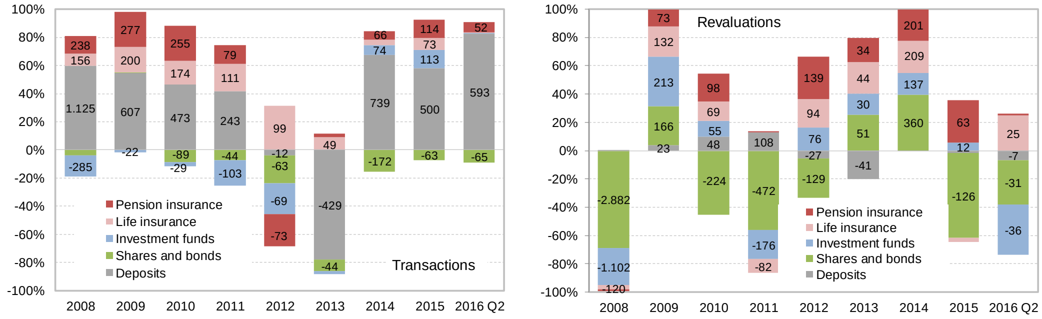
Figure 1.7: Financial assets, liabilities and net financial position as percentages of GDP (left), and breakdown of Slovenian and euro area households' financial assets in percentages (right)



Sources: Bank of Slovenia, SURS, ECB

The net financial assets of households in Slovenia increased by EUR 692 million in the first half of 2016 to stand at 71% of GDP. Households in Slovenia remain relatively less indebted (31% of GDP) than those across the euro area, although they also hold less financial assets. The net financial assets of Slovenian households as a percentage of GDP remains less than half of the average across the euro area. The gap in assets is partly attributable to the structure of financial assets. Households in Slovenia are more conservative, and hold more than half of their assets in the form of currency and deposits, where returns are relatively low. As a result they hold less of the higher-yielding assets such as investment funds and bonds, and life and pension insurance. An increase in the proportion accounted for by life and pension insurance can also be expected in Slovenia in the future, given the demographic changes and the decline in pensions.

Figure 1.8: Breakdown of transactions (left) and revaluations (right) in individual forms of household financial asset in Slovenia, in EUR millions and percentages



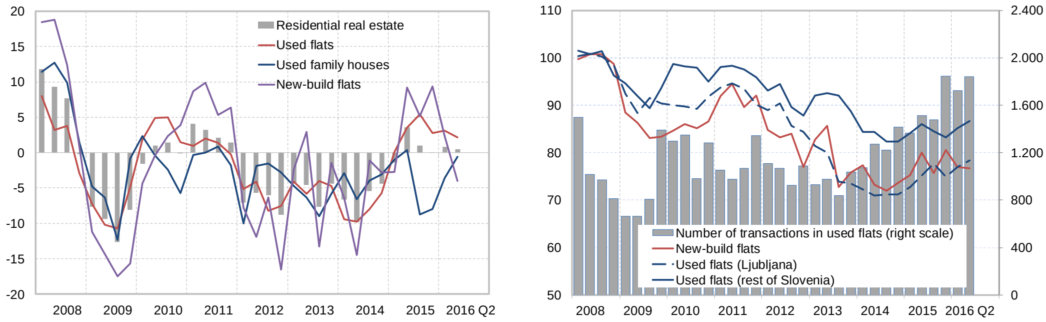
Source: Bank of Slovenia

In the favourable economic situation, improving situation on the labour market and with consumption remaining relatively modest, household deposits continued to increase in 2016. Apart from deposits, the only other increase in household assets was recorded by investments in pension insurance, which nevertheless remain modest. The low interest rate environment is having an adverse impact on returns on pension insurance, which in the wake of changes to the pension system (the pension reform) could contribute to reduced expectations with regard to future pensions. This factor could encourage households to increase their investments in higher-risk forms of pension funds and other funds in the future. The increased uncertainty on the capital markets and the completion of several corporate takeovers by foreign owners reduced share prices in the first half of 2016, while low interest rates brought revaluations of deposits and bonds.

1.3 Real estate market

Residential real estate prices have continued to record moderate growth in 2016. According to SURS figures, the largest year-on-year rise was in prices of used flats, which were up 3% in the first quarter and 2.2% in the second quarter of the year. A lower number of transactions means that there is greater volatility in prices of new-build flats, which suffered a sharp fall in the first half of 2016 after high growth in the previous year.

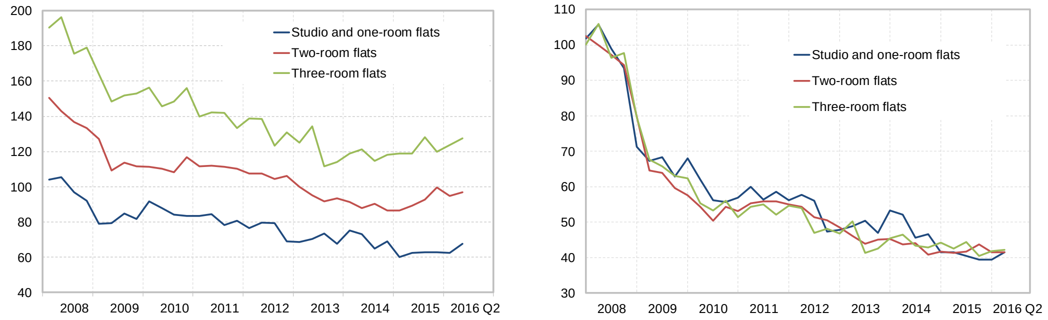
Figure 1.9: Year-on-year growth in residential real estate prices in Slovenia (left), and housing price base index (2008 = 100) (right), in percentages



Source: SURS

The number of transactions in used residential real estate also increased in the first half of 2016 at a faster pace. The ongoing favourable economic situation saw a rise in the number of transactions in 2016 in all types of residential real estate. According to SURS figures, there were more than 3,560 transactions in used flats in the first half of the year, up 24% in year-on-year terms, and the largest figure since the outbreak of the crisis. Despite the recovery, residential real estate prices in Slovenia are still down approximately 20% compared to 2008. A gradual recovery in prices of used real estate is also evident in Ljubljana, where the number of transactions in used flats in the first half of the year was up 20.4% in year-on-year terms.

Figure 1.10: Ratio of housing prices to net wage for Ljubljana in percentages (left), and housing affordability index (2008 = 100) (right)



Note: The left figure illustrates the ratio of prices of used flats to the annual moving average of net monthly wages in Ljubljana. Owing to a break in the data series, average prices are lower in the period since 2015 than in the prior period. The housing affordability index (right figure) is calculated on the basis of prices of used flats, the annual moving averages of monthly wages, and loan terms (interest rates and maturities).

Sources: Bank of Slovenia, SURS

Housing affordability has continued to deteriorate slightly, as real estate prices have risen faster than wages. After several years of decline, the recovery of the real estate market and the moderate growth in real estate prices in Ljubljana have begun to raise the ratio of housing prices to net wages. Purchasing a flat required more net monthly wages than at the end of 2015, although net wages have also begun to gradually rise (year-on-year growth in net wages in Ljubljana stood at 1.3% in the second quarter).

Allowing for loan terms,[1] the housing affordability index remained unchanged in the first half of the year. The difference between the housing affordability indices is attributable to the further improvement in the terms of financing for housing purchases. Interest rates on housing loans have continued to fall, and now average less than 2% (EOM), while the average maturity term of new housing loans is lengthening, and now exceeds 19 years. Similar developments in the housing affordability index can be expected in the future: housing affordability is largely subject to growth in real estate prices and growth in net wages. A smaller impact can be expected from loan terms, in which there is a lack of space for further reductions in interest rates, although no deterioration in terms can be expected in the near future.

The credit standards on housing loans remain unchanged, although there is evidence of a slight easing of loan terms. According to the bank lending survey (BLS), the banks left their credit standards[2] on housing loans unchanged in 2016, despite the favourable economic situation and the improvement in the situation on the labour market. The new consumer credit act, which is expected to be passed by the end of the year, could also bring additional caution on the part of the banks in formulating credit standards. While credit standards remained unchanged, the BLS revealed a slight easing of loan terms[3] on new housing loans. For the moment, improved loan terms are solely evident in the form of a lower margin,[4] while other factors with a beneficial impact cannot be discerned from the BLS. Demand for housing loans is continuing to increase, which is attributable to the positive outlook for the housing market (including the projected developments in housing prices), strengthened consumer confidence and the low level of interest rates.

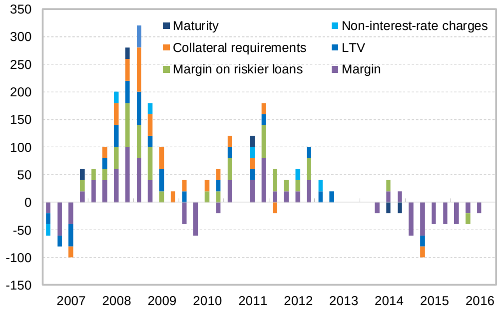
[1] The assumption is that the purchase of the housing is financed entirely by a loan, subject to terms of approval calculated as an average across the banking system.

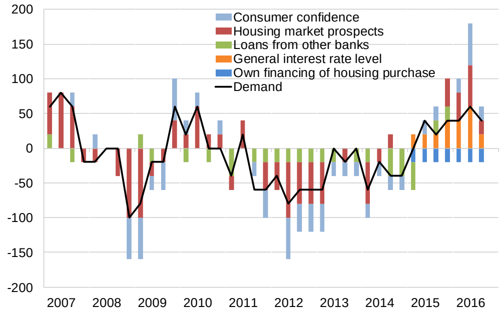
[2] Credit standards are the internal guidelines and criteria according to which a bank approves a loan. They are established before the actual negotiation of loan terms, and before the actual decision to approve or deny a loan. Credit standards define the required attributes of the borrower (e.g. assets, income situation, age, employment status) based on which a loan can be obtained.

[3] Loan terms relate to the terms of a loan actually approved, and are determined in the loan agreement. Loan terms depend on the borrower's attributes, and may be modified in parallel with credit standards, or independently from them.

[4] The premium over the relevant reference interest rate.

Figure 1.11: Loan terms on new housing loans to households (left), and factors affecting household demand for housing loans (right), in percentages



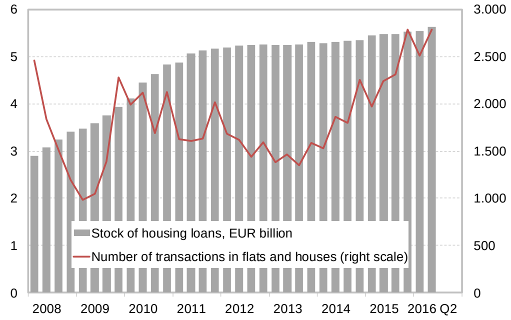


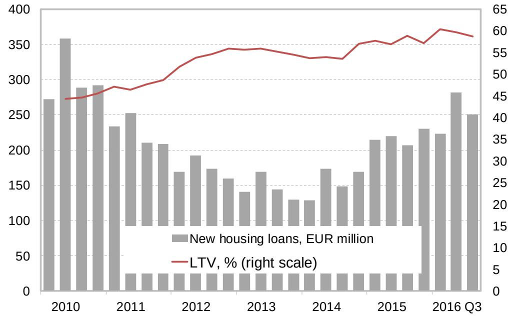
Note: The data in the two figures illustrates the net percentage change on the previous quarter. A net change of more than zero means that the factor is contributing to tightening of loan terms, while a value of less than zero entails an easing of loan terms. In the right figure, a value of more than zero means that the factor is contributing to rise in demand, while a value of less than zero entails reduced demand.
Sources: Bank of Slovenia, BLS

Growth in demand for housing loans is increasingly being reflected in growth in housing loans. The stock of housing loans in September 2016 was up 3.3% in year-on-year terms, and the number of transactions in flats and houses is also continuing to rise, and has exceeded the level at the outbreak of the crisis. The increased optimism and more positive situation on the real estate market are also being reflected in further growth in new housing loans, which were up 17.8% in year-on-year terms over the first three quarters of 2016. Some of the growth is still attributable to changes in the terms on existing housing loans, primarily changes from variable-rate to fixed-rate, and changes in currency or currency clause.

Given the shortage of flats, the rising demand was a factor in the resumption of certain projects suspended during the crisis. The increase in the amount of construction put in place and the rise in the number of building permits issued are signs of the revival of construction activity, although for now there is no evidence of the beginning of a new housing cycle. The supply of housing will remain rather limited in the coming years, which could lead to price rises in the event of further growth in demand. Many people postponed housing purchases because of the financial crisis and the expectation of further price falls. In the wake of increased creditworthiness owing to the favourable situation on the labour market, this could change in the future and could also act to raise demand and the need for new housing. The favourable financing conditions and relatively low real estate prices could encourage greater demand not just from those seeking housing, but also from investors. This could put upward pressure on real estate prices, with potential risk to the banking system.

Figure 1.12: Stock of housing loans to households, in EUR billion, and number of transactions (left), and new housing loans to households, in EUR million, and average LTV, in percentages (right)





Note: The LTV figure for November 2015 is calculated exclusive of two savings banks.
Sources: Bank of Slovenia, SURS

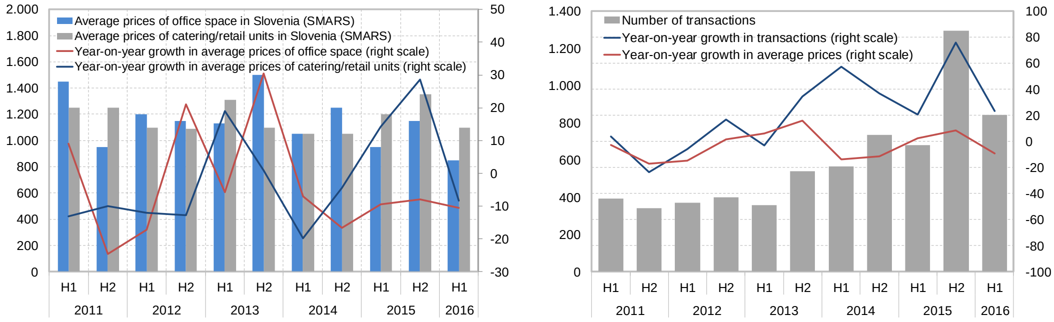
The banks remain cautious in 2016 in terms of collateral requirements during the approval of a new loan. The average LTV for housing loans (the ratio of the loan to the value of the collateral) remained around 60%. The low LTV could be the result of the financing of housing through the significant use of the purchasers' own assets, and the consequent reduced need for a major loan in the purchase of housing. An LTV of 60% does not entail a major risk to the banking system, particularly in light of the projected continuing recovery of the real estate market. The

Bank of Slovenia recently introduced two macroprudential recommendations for the residential real estate market, namely the recommended maximum LTV and DSTI (debt service to income). The recommendations are not significantly intervening in current housing lending activity, but are aimed at preventing or mitigating any future risks to the real estate market.

Commercial real estate market

The rise in the number of transactions in commercial real estate has for the moment not been reflected in price rises. Average commercial real estate prices in the first half of 2016 were down again in year-on-year terms, by 9.3%. After a record second half of 2015, the number of transactions fell, but were nevertheless up 24% on the first half of 2015. The relatively small and heterogeneous sample of commercial real estate leads to significant price volatility, and it is consequently difficult to assess any reversal in the trend of decline. The falls of 10.5% in prices of office space, and 8.3% in prices of catering and retail units in the first half of the year suggest that a reversal has not yet come about. Commercial real estate in Slovenia is concentrated in the major towns and cities and in large retail and commerce centres, while in addition the leasing market is a strong competitor to the sales market. The rise in the number of transactions in commercial real estate is indicative of a reversal in the future, although owing to the aforementioned attributes of commercial real estate the reversal can be expected to be delayed compared with other types of real estate.

Figure 1.13: Average prices, in EUR per m^2, and year-on-year growth in average prices of offices and catering/retail units, in percentages (left), and number of transactions and year-on-year growth in transactions and average prices of commercial real estate, in percentages (right)



Note: Year-on-year growth in average prices of offices and catering/retail units is calculated in terms of the average price per square metre. The figures for average prices are calculated per square metre of useful space on the basis of a sample. Office space and catering and retail units have been classed as commercial real estate. The methodology has changed slightly between years, which could have an impact on the data.

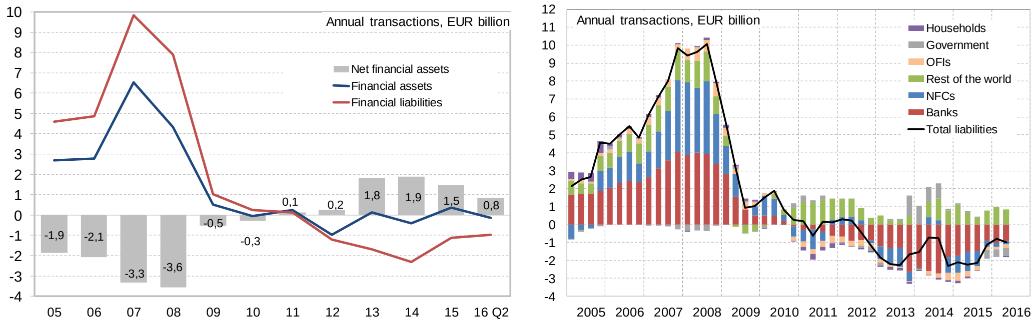
Source: SMARS

1.4 Non-financial corporations

Changes in the stock and method of corporate financing

Non-financial corporations have been adjusting their balance sheets for six consecutive years now by reducing borrowing at domestic banks and also from other domestic institutional sectors. They are financing themselves via the rest of the world and internal resources. After 2011 non-financial corporations became net financers of other domestic institutional sectors via current financial assets. Even the banking sector became a net debtor vis-à-vis non-financial corporations in terms of annual transactions in 2011: in individual years non-financial corporations placed more in deposits with banks than they received in loans raised. Before this the Slovenian banking system was a more important source of financing for Slovenian non-financial corporations. Despite rising profits, non-financial corporations have reduced their investment rate and increased their net positive financial position since 2011, thereby increasing the security reserve and simultaneously deleveraging. The higher level of liquid assets allowed them to protect against mismatching between inflows and outflows, and the uncertainty of future cash flows. There was a sharp increase in the amount of outstanding past-due trade payables after 2009, and a simultaneous rise in the number of non-financial corporations against whom bankruptcy proceedings were initiated.

Figure 1.14: Financial assets, liabilities and net position of non-financial corporations (left), and non-financial corporations' liabilities and borrowing by institutional sector (right), annual moving sum of transactions, in EUR billion

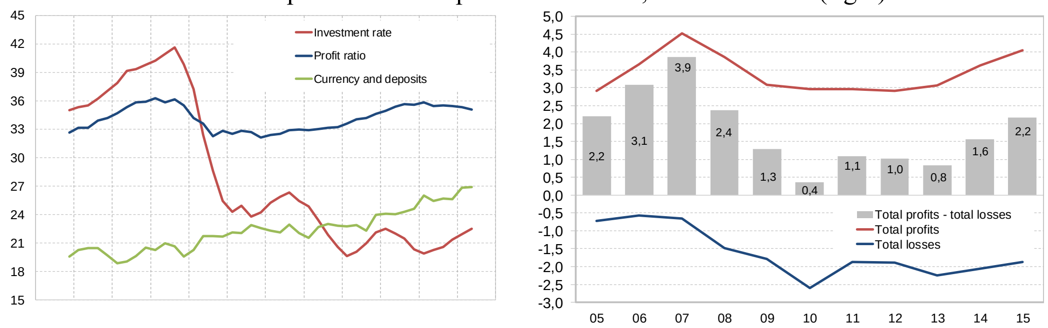


Source: Bank of Slovenia

Non-financial corporations recorded rising profits in the years just before the outbreak of the crisis. They were net borrowers of financial assets, particularly from the banking sector and within the non-financial corporations sector. This was reflected in their increasing net negative financial position, which surpassed EUR 3.5 billion in 2008. In this period non-financial corporations reached an investment rate of 40%, making corporate investment by far the largest contribution to GDP growth. The high growth in value-added before 2008 was also attributable to construction activity, which owing to overheating was also hit hardest by the crisis. Investment stopped at the outbreak of the crisis. Total national investment accounted for just 0.6 percentage points of GDP growth in 2015.

In 2015 there was an increase in non-financial corporations' investment rate, which reached 22.5% in the first half of 2016. Non-financial corporations were able increase profit, partly as a result of stable economic growth. The increase in non-financial corporations' surplus assets after 2011 brought a reduction in their leverage, primarily via debt repayments, and to a lesser extent via an increase in equity. It is expected that non-financial corporations will use their surplus assets to increase investment activity, which will provide an additional stimulus to economic growth. Non-financial corporations increased their holdings of currency and deposits to 27% of their annual gross value-added, despite interest rates of virtually zero and fees for large-value deposits. The increase in corporate investment activity is being financed primarily from internal resources, i.e. retained earnings, and partly from foreign resources. At the same time the increase in investment activity has brought a discernible decline in non-financial corporations' net positive financial position and a slowdown in growth in their bank deposits. Growth in their bank deposits can be expected to decline as investment activity recovers.

Figure 1.15: Non-financial corporations' gross investment rate, gross profit ratio, and holdings of currency and deposits as a percentage of annual gross value-added (left), and non-financial corporations' total profits and losses, in EUR billion (right)

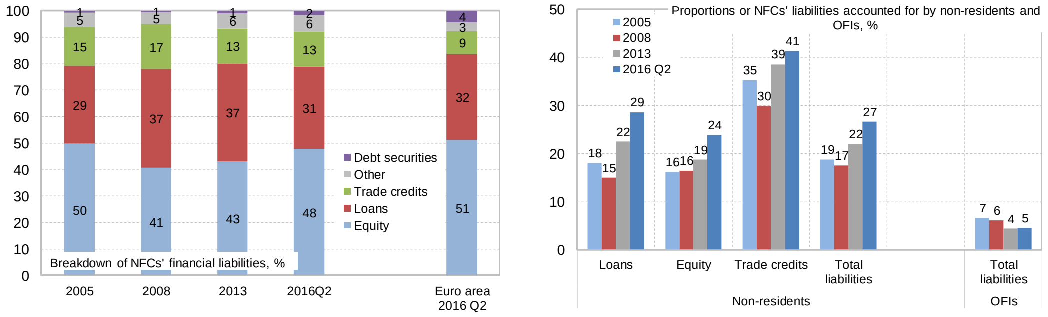


Note: The gross investment rate is the ratio of gross investment to value-added. The gross profit ratio is the ratio of gross operating surplus to gross value-added.
Sources: Bank of Slovenia, SURS, AJPES

Change in structure of corporate financing

The structure of the financing of Slovenian non-financial corporations has gradually begun to converge on that seen across the euro area, where bank loans are less important. Before the crisis year of 2008, when non-financial corporations' financial liabilities reached 235% of GDP, non-financial corporations increased the proportion of their financial liabilities accounted for by loans, while the proportion accounted for by equity declined. At the end of the first half of 2016 non-financial corporations' financial liabilities amounted to just over 200% of GDP, 4 percentage points less than in the period of sustained economic growth between 2001 and 2005. The proportion accounted for by loans was 5 percentage points higher, and the proportion accounted for by equity was the same amount lower compared to the aforementioned period. The structure of financing has converged much more closely on that seen across the euro area. Non-financial corporations across the euro area have more equity and more financing via bond issues, which is only slowly gaining in importance for non-financial corporations in Slovenia. The period of low interest rates encouraged interest on the part of Slovenian non-financial corporations in issuing debt financial instruments, although the small size of the issues and the complex issuance procedures remain problematic for them.

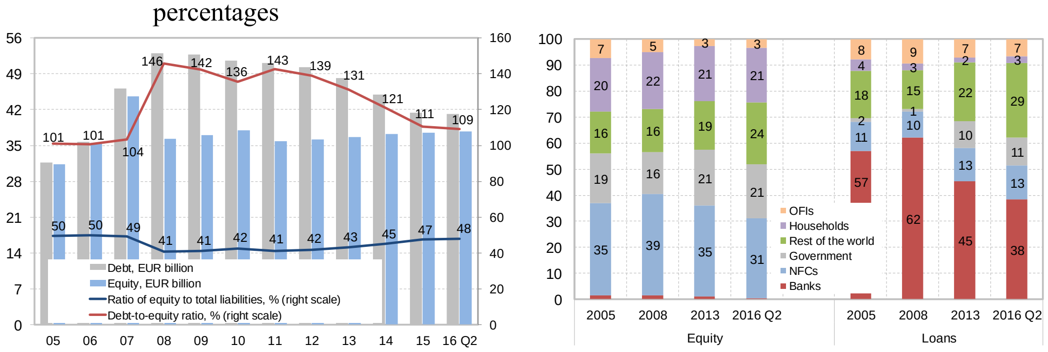
Figure 1.16: Breakdown of Slovenian non-financial corporations' financial liabilities (left), and proportion of major types of liability accounted for by non-residents and proportion of total financial liabilities accounted for by other financial intermediaries (right), in percentages



Source: Bank of Slovenia

The ownership structure of the non-financial corporations sector has changed in recent years, although this has not brought a significant increase in equity. The proportion of non-financial corporations' equity held by non-residents increased to almost a quarter. The government sector holds 21% of non-financial corporations' equity. The proportion of government ownership remains high, partly as a result of the transfer of banks' non-performing claims to the BAMC, which falls under the government sector. Slovenian Sovereign Holding has succeeded in selling nine of the 15 firms on its privatisation list compiled in 2013. It planned to begin the sale process for 25 additional firms in 2016, while the tender process for the sale of shares is in progress for 13 firms. The main decline in non-financial corporations' ownership structure since 2008 has been in non-financial corporations' equity holdings, which is the result of failed management buyouts before 2008 and the related capital shortfalls at Slovenian non-financial corporations. In 2010 the proportion of equity held by non-financial corporations declined to its level of the period between 2001 and 2005, when the situation was more stable, and had declined further to 31% by the end the first half of 2016.

Figure 1.17: Corporate debt-to-equity ratio (left), and breakdown of ownership structure of and lenders to Slovenian non-financial corporations by institutional sector (right), in percentages



Note: OFIs are non-monetary financial institutions.
Source: Bank of Slovenia

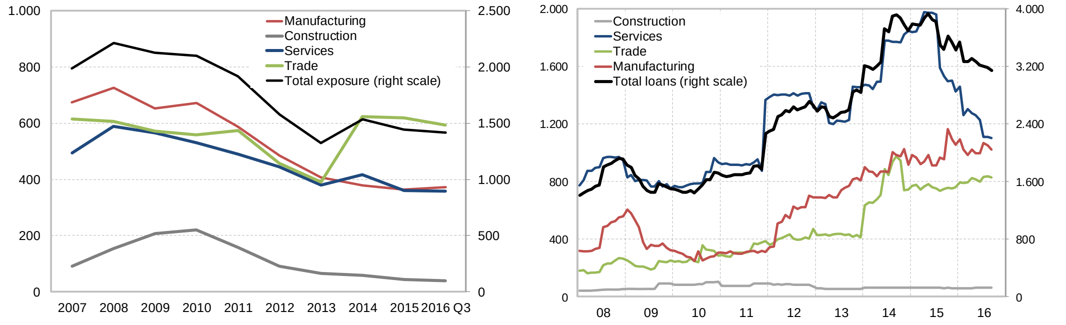
The corporate debt-to-equity ratio is comparable to the euro area median at around 110%. The level of corporate debt in terms of GDP is below the euro area average. The decline in the debt-to-equity ratio in Slovenia has been based on a reduction in liabilities, and not on an increase in equity. Non-financial corporations also require capital strength to achieve sustained long-term growth in investment and appropriate growth in productivity. Some firms are still under pressure to meet capital adequacy requirements in demand for bank loans. At the same time firms under majority foreign ownership obtain a significant amount of financing in the rest of the world. The rest of the world accounts for more than a quarter of non-financial corporations' total liabilities. Slovenian banks are thus losing a certain portion of the demand. The fall in commercial real estate prices to below their pre-crisis levels means that non-financial corporations have also lost part of their collateral for bank loans, which is limiting their demand for bank loans.

Reduced demand for bank loans in Slovenia as a result of changes in the ownership structure of the economy

Analysis of Slovenian banks' exposure to non-financial corporations owned by non-residents reveals that firms where foreign ownership is more than 50% account for a relatively small proportion of total exposure: EUR 1.4 billion or around 11%. Exposure to all firms with foreign capital, including those with minority holdings by non-residents, is also small, at around 15% of the total. Slovenian banks' exposure to firms under majority foreign ownership has declined since 2009 (with the exception of 2014), although in recent years by less than that to firms with no foreign ownership. The proportion of total bank exposure to non-financial corporations accounted for by firms under majority foreign ownership has thus increased since 2013. The reason lies in the sharp contraction in bank loans to non-financial corporations, partly as a result of transfers to the BAMC, and not as a result of increased financing of firms under majority foreign ownership by Slovenian banks. The correlation between the change in the banks' exposure to these firms and the change in the proportion of equity held by non-residents between 2013 and 2015 was also negative, in the amount of approximately 0.12. The sample encompassed firms where non-residents' holding of equity increased to above 50% in the aforementioned period, whereby the foreign owner was responsible for the decision to raise a loan. Large enterprises accounted for the majority (around 70%) of the banks' exposures to firms under majority foreign ownership at the end of 2015, of which merely just under 4% were more than 90 days in arrears.

Loans received from foreign firms are increasing in importance in corporate financing from the rest of the world. More than 85% of such loans are made to Slovenian firms under majority foreign ownership. The proportion of foreign lending to Slovenian firms accounted for by loans received from foreign banks and foreign international institutions is declining, while the proportion accounted for by loans received from foreign firms is increasing. The latter have increased by 135% since the end of 2011, reaching EUR 2.7 billion in September 2016. In the breakdown of lenders to Slovenian firms the proportion accounted for by non-residents has consequently been increasing, and reached almost 30% by June 2016, while the proportion accounted for by loans from the domestic banking sector is declining. It is down 24 percentage points on 2008, at 38%. The largest amount of loans from the rest of the world are received by the service sector (predominantly transportation and storage, professional, scientific and technical activities, and real estate activities), which has seen a decline in this source of financing since mid-2015. Just over 40% of such loans were made to firms in the service sector under majority foreign ownership. Since 2010, when there was a contraction in loans at Slovenian banks (among firms under majority foreign ownership), the manufacturing sector has increased its loans received from the rest of the world. There has been a similar occurrence in the wholesale and retail trade sector, which has maintained its borrowing from Slovenian banks despite sales to non-residents.

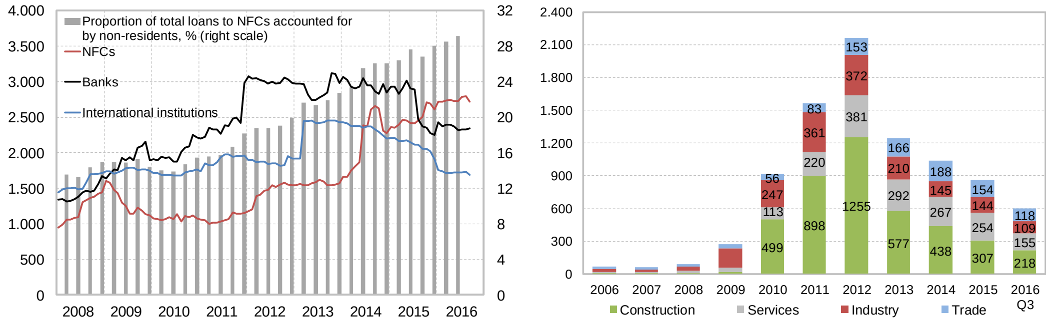
Figure 1.18: Exposure of domestic banks to firms under majority foreign ownership (left), and loans from the rest of the world to firms under majority foreign ownership (right), by sector, in EUR million



Note: The figure for the level of foreign ownership is an annual figure, which is available in the middle of the year for the previous year. The exposure for 2016 is therefore calculated with regard to ownership in 2015.
Source: Bank of Slovenia

The clean-up of firms in bankruptcy on bank balance sheets is anticipated and desirable, however simultaneously indicates the loss of demand for bank loans as a result of the financial crisis and the resulting shifts in the structure of the economy. Firms that have entered bankruptcy since 2009 held EUR 5 billion of exposures vis-à-vis domestic banks at the end of 2009. By September 2016 the domestic banking sector's exposure to these firms was merely around EUR 600 million. Economic growth is being driven by manufacturing and services, while construction is far less important. The financing of construction firms has declined sharply since 2008. The domestic banking sector's exposure to construction firms stood at EUR 3.2 billion in 2009, but merely just over EUR 1 billion in September 2016 (a decline of 63%). In 2012, when total exposure was still more than EUR 3 billion, some 39% of these exposures were to construction firms in bankruptcy, while the corresponding figure had fallen to 19% by September 2016. Slovenian banks' exposure to manufacturing stood at almost EUR 6.6 billion in 2009, but had fallen to EUR 3.4 billion by September 2016 (a decline of 48%). There has not yet been increase in domestic bank loans to manufacturing, which could be a consequence of the adequacy of their financial surpluses and the financing obtained from the rest of the world, but could also imply that the level of investment is not yet high enough, or could be attributable to caution on the part of firms and banks. The proportion of exposure accounted for by firms in bankruptcy in the manufacturing sector peaked in 2012 at 6%. The loss of demand from manufacturing was extremely large in nominal terms during this period, although the proportion of exposure accounted for by firms in bankruptcy was significantly lower than in the construction sector. It was necessary for construction to be re-established in Slovenia, although its importance from the perspective of macroeconomic stability should never be allowed to be as large as in the years of economic overheating before the crisis.

Figure 1.19: Corporate loans from the rest of the world by non-resident institutional sector (left), and banking system's exposure to firms in bankruptcy by economic sector (right), in EUR million



Source: Bank of Slovenia

2 RISKS IN THE BANKING SECTOR

The risks in the banking sector diminished further over the preceding six months, with exception of interest rate risk and a trend of potential rise in income risk. With regard to credit risk, there was a notable decline in the stock and proportion of non-performing claims. In conjunction with the impact of the favourable macroeconomic environment on the performance and financial position of bank customers, impairment and provisioning costs have declined and have had a beneficial impact on income. The structure of bank funding is increasingly based on domestic resources and less on wholesale funding, although their stability is declining as a result of shortening maturities. Interest rate risk remains at a relatively high level, with a trend of further deterioration, particularly as a result of the lengthening of the average repricing period for assets. The opening of the maturity gap between investments and funding is increasing the importance of liquidity adequacy at banks. The banks' secondary liquidity is high, with a large proportion of Slovenian government securities. As a result of Slovenia's upgrading, these do not entail a major concentration risk.

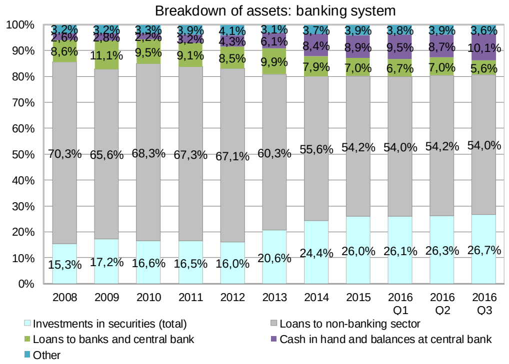
A major risk to bank performance comes from the persistent low interest rate environment, which could lead to another rise in income risk, particularly in the event of a further decline in lending to the non-banking sector and the maturing of higher-yielding investments in securities. In the event of a deterioration in bank profitability, which could reduce the capacity to generate internal capital, solvency risk could also increase again.

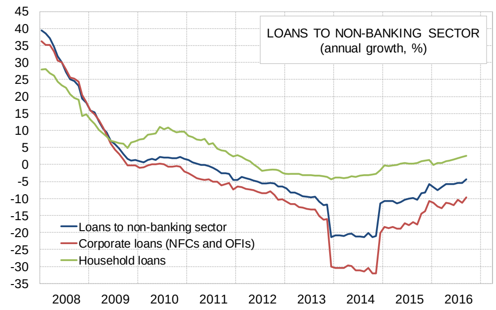
2.1 Banking system's balance sheet and investments

The shift in Slovenian banks' investment structure slowed in 2016, but the structure has not yet stabilised. The banks are still holding a large proportion of their investments in the most liquid forms of asset, securities and claims against the central bank. The proportion of total assets accounted for by loans to the non-banking sector stood at 54% in September 2016, having declined to a level similar to that when Slovenia joined the EU, i.e. before the beginning of the rapid expansion of bank balance sheets. The contraction in loans to the non-banking sector is slowing, albeit primarily as a result of growth in household lending, which also gained impetus in the consumer loan segment in 2016. Corporate lending is continuing to contract, albeit slightly more slowly than in previous years, but this situation is persisting, owing to the maintenance of the same limiting factors on the supply side and the demand side. A significant limiting factor on the supply side is the commitments made to the European Commission with regard to the required return on new corporate loans at the banks that have received state aid, which in the low interest rate environment have become unattainable. On the demand side there has been a discernible positive shift in the direction of more demand for loans for investment at the expense of loans for restructuring, which is a reflection of a healthier structure in corporate demand. Nevertheless there is no expectation of lending and demand at the level seen in the years before the financial crisis, owing to the change in the structure of the economy and the models of corporate financing, which are based more on internal resources and resources outside Slovenian banks.

The banks' investments in securities in 2016 remained at the nominal level seen at the beginning of the year, although the contraction in total assets means that their proportion of the total has increased further. The increase in the proportion accounted for by investments in securities over the last three years is primarily the result of the recovery of certain banks in late 2013. Over the last two years the increase in investments in securities on bank balance sheet has also been attributable to revaluation, prices of Slovenian government securities and other European sovereigns having risen following the stabilisation of the situation in the banking system. Debt securities, mostly Slovenian, account for the majority of the securities.

Figure 2.1: Breakdown of total assets by most important investment categories (left), and year-on-year growth in loans to the non-banking sector (right), in percentages





Source: Bank of Slovenia

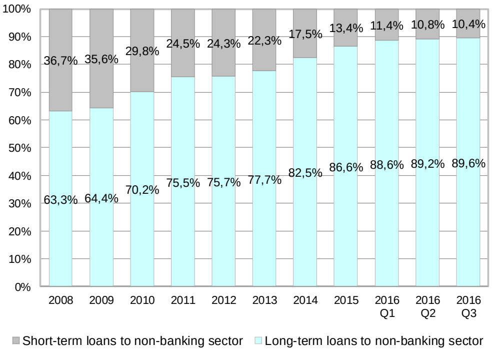
The contraction in lending to the non-banking sector slowed in 2016. The year-on-year decline in loans to the non-banking sector in the Slovenian banking system stood at 4.3% in September 2016, down from 5.9% at the end of 2015. One factor in the contraction in lending activity was the wind-down of Factor banka and Probanka at the beginning of the year; excluding the two aforementioned banks the year-on-year decline in loans to the non-banking sector would be 2.7%. The main factor in the contraction in the banks' total lending activity is the continuing negative growth in corporate loans.

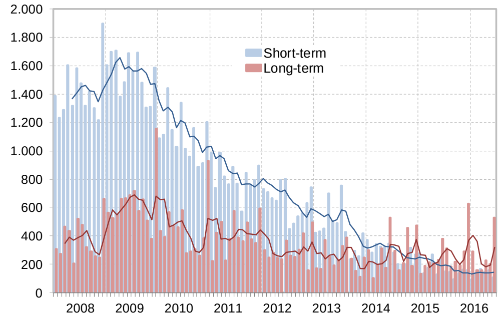
Loans to non-financial corporations continued to decline in 2016. The year-on-year decline in loans to non-financial corporations stood at 9.7% at the end of the third quarter of 2016, just 1 percentage point less than at the end of 2015. Excluding Factor banka and Probanka, the year-on-year decline would stand at 7.2%. Despite the improvement in the economic situation and the favourable conditions created by loose monetary policy, which have been reflected in high surplus reserves at the banks, the fall in asset interest rates over the last two years and the relaxation of credit standards, the banks are not strengthening their corporate lending activity.

Bank lending activity is declining, as a result of factors on both the supply side and the demand side. The supply-side factors include the maintenance of credit standards at high levels, the commitments that the banks that received state aid made to the European Commission, whose withdrawal would have a positive impact on lending, and regulatory changes at the global level, which are placing a temporary burden on banks. Even more significant are the limiting factors on the demand side, in particular changing structure of the economy, and the increasing use of internal resources and non-bank resources in corporate financing. The data indicates that the decline in demand for corporate loans seen over the last several years is continuing (see Box 1). Given the surplus of saving over investment at firms, the deleveraging of the economy is likely to continue, while in the wake of further changes in the structure of the economy and the rising importance of other resources in corporate financing the possibility of a significant increase in lending is diminishing.

The average maturity of corporate loans is lengthening as mainly long-term loans are approved. In the wake of the sustained contraction in short-term loans (the stock of loans is declining, as are new loans, which are down around a fifth in year-on-year terms), and given that firms have relatively large holdings of sight assets at banks, there has been a sharp increase in the proportion of corporate loans accounted for by long-term loans, which stood at 86% in September.

Figure 2.2: Maturity breakdown of loans to the non-banking sector (left), and new loans to non-financial corporations, in EUR million (right)





Source: Bank of Slovenia

Household loans are gradually increasing: year-on-year growth reached 2.6% in September. Growth in housing loans, which has remained positive ever since the outbreak of the crisis, increased to 3.5%. The gradual increase in growth is attributable to low household indebtedness, low interest rates on loans and relatively favourable real estate prices, and the fact that the banks are increasingly focusing on households as corporate lending contracts. After several years of contraction, year-on-year growth in consumer loans has been positive since April 2016 and is continuing to increase, reaching 3.2% in September. The increase in growth in consumer loans is attributable to the improved economic environment and the improvement in conditions on the labour market. Increased household expenditure on durables, which could be related to the growth in housing loans, is partly being reflected in increased demand for consumer loans.

Processes that have been underway for several years, on both the investment side and the funding side, have resulted in a change in the structure of bank balance sheets. On the investment side there has been an increase in the proportion accounted for by the most liquid forms in recent years, the figure reaching 10%. The banks hold just under 27% of their assets in securities, several percentage points above the long-term average. The proportion accounted for by loans to the non-banking sector stood at 54% in September, down 5 percentage points on its long-term average.[5] However, the breakdown of loans by institutional sector has also changed significantly. Between Slovenia's entry into the EU in 2004 and September 2016, the proportion of loans to the non-banking sector accounted for by non-financial corporations declined by 24 percentage points to stand at 39%, while the proportion accounted for by household loans increased by 19 percentage points to 44%. Loans to non-financial corporations have been lower than household loans since October 2015. In terms of institutional sector, the investment breakdown has changed more than the breakdown of bank funding.[6]

Box 1: Demand for loans from non-financial corporations

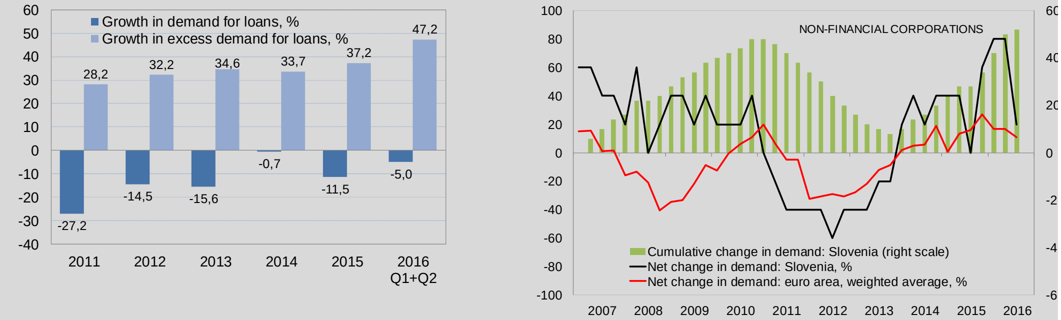
The survey on corporate demand for loans conducted at banks and savings banks by the Bank of Slovenia on an annual basis reveals the continuation of the trend of decline in demand for bank loans. After the trend of declining demand seen for several years had slowed, a renewed larger decline of 11.5% in year-on-year terms was reported in 2015, and a slightly smaller decline was reported in the first half of 2016. The survey results differ from the results of the ECB's quarterly survey of lending and credit standards (the Bank Lending Survey), which suggests that corporate demand at Slovenian banks has been increasing since 2014.

The differences in the trend in demand between the two surveys are attributable to differences in the type of data reporting. In the BLS banks merely provide a qualitative assessment of changes in demand (and the factors affecting it), while in the Bank of Slovenia's annual survey they report the amount of corporate demand in value terms itemised by the sector of the firm, the type of loan, and the grounds for refusal of loan applications.

[5] Average between 2000 and September 2016.
[6] Were the period of large-scale wholesale funding in the rest of the world, when the proportion of bank funding accounted for by deposits was below-average, to be ignored, the figure of 70% for the proportion accounted for by deposits by the non-banking sector at the end of September 2016 would be comparable to that seen in mid-2003. By contrast, the proportions of total deposits accounted for by households (64%) and corporates (21%) do not differ significantly from their long-term averages of 62% and 18% respectively. For more on funding, see the section entitled *Bank funding risk and liquidity*.

At certain, generally larger, banks, the amount of demand may be under the influence of lower demand from individual larger debtors, who have secured their financing requirements for current operations and investment purposes from other external resources, or through the generation of internal resources facilitated by increased profitability or the establishment of a network of financing by new owners. By contrast, the banks' qualitative assessment of increased demand in the BLS could entail increased demand from SMEs, which is expressed in a larger number of applications, and only to a lesser extent in the amount of demand in value terms. Further evidence of this supposition comes from the survey of SME financing, which cites the improved supply of bank loans to this group of firms. The SURS survey on limiting factors in performance also no longer cites financing difficulties in first place, as it had in the past.

Figure 2.3: Corporate demand for loans on the basis of annual (left) and quarterly (right) surveys

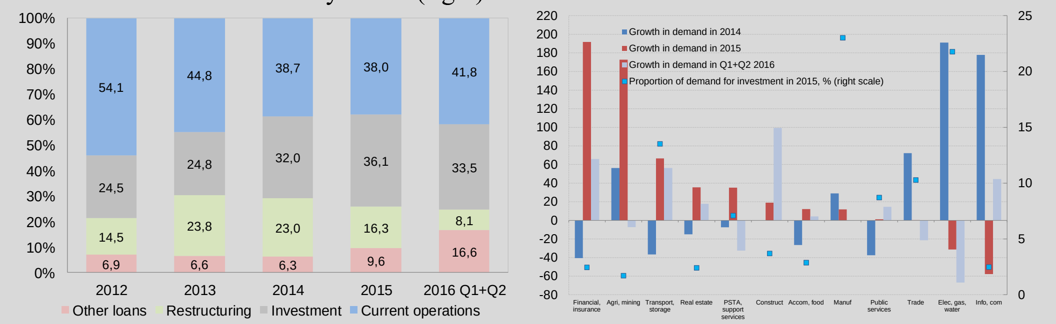


Sources: Bank of Slovenia, ECB

Total demand for loans from non-financial corporations increased in 2015 at eight of the 17 banks covered by the survey. These banks accounted for 32% of total demand. The largest growth in demand was at the savings banks, although their relatively small size means that the impact on the banking system's total demand was small. The increase in demand at the savings banks was reflected in increased credit growth, and consequently in a lower rate of excess demand.

The changes in the structure of corporate demand for loans indicated in 2014 continued in 2015. Most notably demand for loans for restructuring, which in previous years was the prevailing form of demand, continued to decline sharply. In the wake of the improvement of the quality of the credit portfolio and the revival of economic activity, and increased corporate investment activity, the proportion of loans for investment has begun to increase. Overall demand for investment loans in the banking system was down slightly in year-on-year terms, although the exclusion of a single bank (not one of the larger banks) would result in an aggregate increase of 13% in demand for investment. After several years of decline, demand for loans for current operations also began increasing in the first half of 2016, while there was an even bigger increase in demand for "other loans", where banks cited several purposes or no particular purpose.

Figure 2.4: Breakdown of demand for loans by purpose (left), and growth in demand for loans for investment by sector (right)



Source: Bank of Slovenia

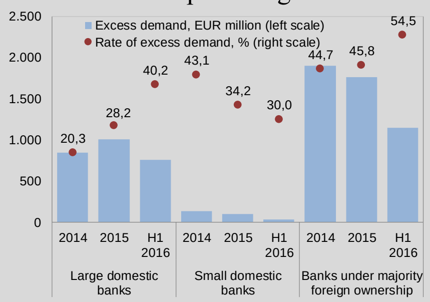
Demand for loans for investment increased in 2015 in the majority of sectors and at the majority of banks. The sectors in which demand for loans for investment increased accounted for three-quarters of total demand of this type, as the only notable decline in demand was recorded by the electricity, gas and water sector, which can be classed as one of the sectors with large demand and a low rate of loan refusals.[7]

The ongoing decline in demand has seen a further increase in excess demand, i.e. that part of demand that did not result in the approval of a loan. The rate of excess demand[8] stood at 37.2% in 2015, up 3.5 percentage points on 2014. The increase continued in the first half of 2016, when it was up 3 percentage points in year-on-year terms. The higher rate of excess demand in the first half of the year is seasonal (in previous surveys the half-yearly rate also showed an upward deviation from the annual rates subsequently reported).

As in previous surveys, in 2015 and 2016 the rate of excess demand was highest at the banks under majority foreign ownership, although on this occasion the large domestic banks are notable for the increase in the rate. The rate reached 28% in 2015, primarily as a result of an increase in demand for and the rate of excess demand for loans for investment, which increased the most sharply at this bank group. At the banks under majority foreign ownership 46% of demand was refused, a similar figure to the previous year. By contrast, the rate of excess demand declined further at the small domestic banks and savings banks. A stronger increase in demand was particularly evident at the savings banks in 2015 and 2016, which was largely matched by new loans. There was a seasonal increase in the rate in the first half of 2016 at all the bank groups.

The largest excess demand was recorded by loans for investment, which entail a higher risk for banks because of the larger amounts required and the generally longer maturities.

Figure 2.5: Excess demand for loans and rate of excess demand by bank group, in EUR million and percentages



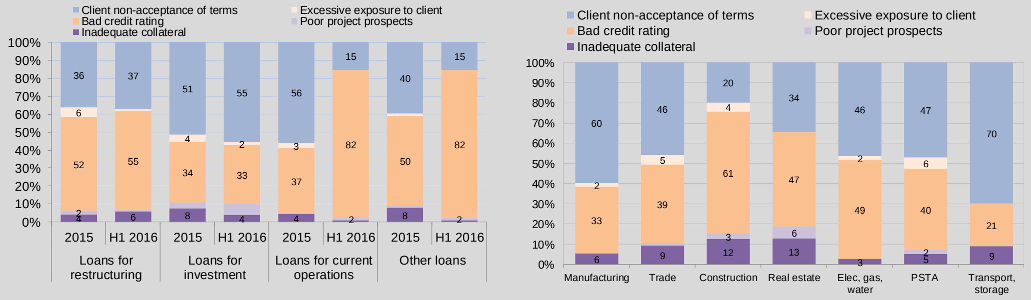
Source: Bank of Slovenia

A bad credit rating and the client's non-acceptance of the bank's terms are the most common reasons for loan refusal. The reasons vary according to the type of loan, but a bad client rating is prevalent for loans for restructuring purposes. The client's non-acceptance of the terms, which is the prevailing reason for the failure to conclude an agreement for loans for investment, is indicative of a stronger position on the part of such clients owing to alternatives for financing outside the banking system. "Poor project prospects" accounts for a negligible proportion of loan refusals: the highest figure is for loans for investment, although it is relatively low compared with other reasons. The highest level of client non-acceptance of the bank's terms is in manufacturing, where it accounts for 60% of loan refusals, while the figure is also high in transport, wholesale and retail trade, and certain services. In the search for investment opportunities within the framework of increased corporate lending, the segment of loans for investment is the greatest challenge for the banks, particularly from the perspective of their higher risk, but also from the perspective of the loss of income in the event of the loss of a creditworthy client.

[7] To a greater extent than in other sectors, the large demand in this sector is an indicator of simultaneous demand at a large number of banks.

[8] Excess demand is calculated as the difference between the amount of demand and the amount of newly approved loans. The rate of excess demand is calculated as the ratio of excess demand to the amount of demand, expressed as a percentage.

Figure 2.6: Breakdown of reasons for loan refusal for different sectors (left) and for different types of loan (right), in percentages



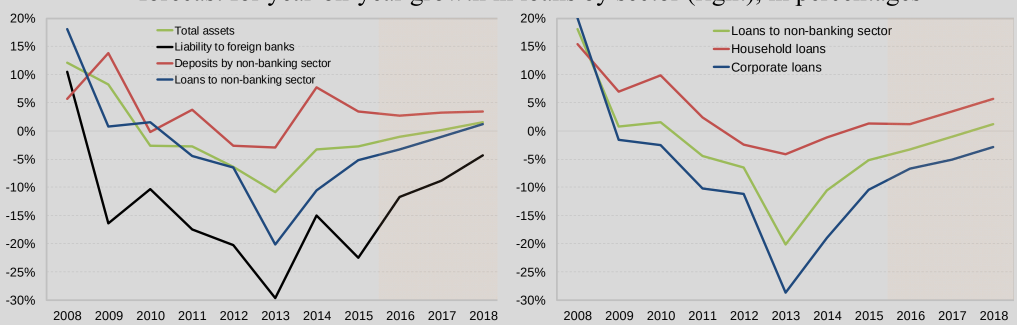
Note: "Other reasons" is omitted from the illustration.
Source: Bank of Slovenia

Box 2: Forecasts of bank performance, 2016 to 2018

This box presents forecasts for the main categories in bank balance sheets over the period of the next two to three years, which are then compared with the forecasts reported by the banks within the framework of their funding plans. The forecasts are part of the macro stress tests conducted by the Bank of Slovenia each year, and are one of the key tools for assessing the stability of the banking system over the medium term, and an important input for macroprudential policy in the years ahead.

According to the Bank of Slovenia's forecasts, the contraction in the banking system's turnover is slowing, but growth in total assets will remain negative in 2016. According to the Bank of Slovenia, total assets will attain weak growth in 2018. The changing structure of the economy and still present risk aversion, both on the part of banks and on the part of clients, will keep growth in loans to the non-banking sector negative in 2017, particularly in corporate lending. Uncertainty remains an important factor, as a result of the financial crisis, unemployment, the unstable and rigid business environment, and geopolitical instabilities. The banks are adjusting their business models, and are focusing more on the household segment. Investments in securities are becoming the largest single item on the asset side. The change in asset structure is also changing the breakdown of the risks to which the banks are exposed. Credit risk remains significant, while the risk of maturity mismatch between assets and liabilities, interest rate risk and market risk are all increasing in significance.

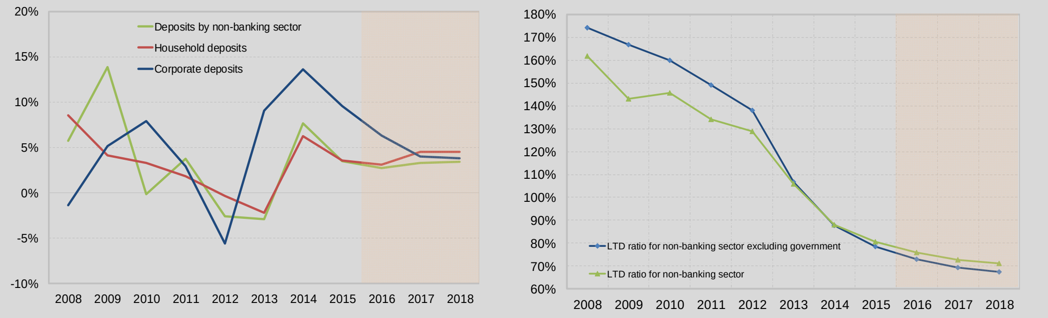
Figure 2.7: Forecast for year-on-year growth in main balance sheet categories (left), and forecast for year-on-year growth in loans by sector (right), in percentages



Source: Bank of Slovenia

On the liability side, the banks are replacing more expensive funding sources with cheaper ones, most notably sight deposits. As long as interest rates remain so low, the increase in the proportion of sight deposits is bringing the banks the beneficial effects of lower interest expenses, but it could bring additional instability into the funding structure. Sight deposits by the non-banking sector account for 43% of the banking system's total liabilities, a historically high figure, although given the anticipated persistence of low interest rates it is expected to increase even further, both as a result of the inflow of new deposits and as a result of switching from fixed-term deposits to sight deposits. Under normal circumstances sight deposits have a very favourable ratio between funding cost and stability. While the zero bound on interest rates for customers in the environment of negative interest rates on the interbank market means that sight deposits are becoming one of the more expensive sources of funding in this maturity segment, they could also be less stable, as estimated by the banks on the basis of past data. Coverage of sight deposits by liquid assets is declining.[9] It therefore seems reasonable to adjust banks' business policies to find appropriate balance between stability and yield, and maintaining adequate capital and liquidity buffers. In the context of a weak recovery in lending, growth in deposits by the non-banking sector of 3% over the next two years means that the LTD ratio for the non-banking sector will decline slightly further, reaching 70% by 2018.

Figure 2.8: Forecast for growth in deposits by sector (left), and LTD ratio (right), in percentages



Source: Bank of Slovenia

Despite good performance in 2016, there remains a question over the long-term viability of the banks' business models. The persistence of the low/negative interest rate environment is hindering bank performance; the banks are responding to the situation primarily via short-term strategies of cost optimisation (funding costs, operating costs and impairment costs), which are not necessarily viable in the long term. The combination of the contraction in turnover and the fall in interest rates is reducing the banks' capacity to generate income. It is therefore less expected that the level of profit that the banks could achieve this year will be sustained in the years ahead. The banks will focus more on products that bring net non-interest income, although this is also conditioned by the size of turnover. The reduced expectations with regard to gross income in 2017 and 2018 entail a lower absorption capacity on the part of the banks to cover credit risk losses. Prompt identification of the need for additional impairments will therefore be vital in the creation of impairments. The problem of structurally low returns and income risk remain one of the key risks that the banks will deal with over the upcoming medium term.

Credit parameters will improve, although as long as the default rate exceeds growth in loans, the proportion of non-performing claims will increase, excluding any mitigation measures. The Bank of Slovenia is expecting that the banks will neutralise the increase in new non-performing claims by means of mitigation measures, i.e. the transition of defaulters to non-defaulters, and the sale or write-off of non-performing claims, as a result of which the proportion of non-performing claims will remain stable in the future, or can even decline slightly in the event of major sales. However, it is important that the focus primarily lie on increasing the transition of defaulters to non-default status, which maintains the banks' turnover and the basis for generating income. The level of financial intermediation and the capacity for a stable economic recovery are also maintained in this manner.

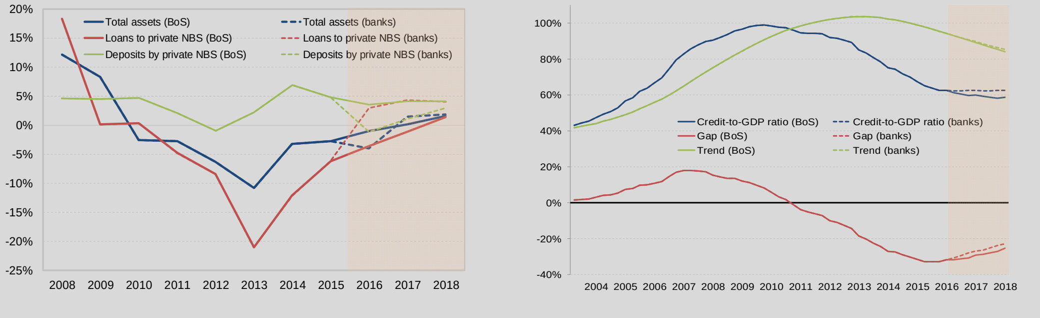
The banking system as a whole has reached a satisfactory level of capital adequacy. Capital adequacy will be strengthened even further by retained earnings. The banking system also has sufficient capital adequacy for the final resolution of non-performing claims, although capital is unevenly distributed across the banks. The existence of a market for non-performing claims between banks could contribute to faster resolution and an improvement in the quality of the credit portfolio. Despite the high capital adequacy at system level, individual banks could face a capital shortfall in adverse circumstances. The retention of earnings in capital is therefore important, if

[9] Coverage of sight deposits by the most liquid assets declined by 15 percentage points in 2016 to 109% in the residual maturity bucket of up to 30 days, and by 18 percentage points to 122% in the residual maturity bucket of up to 180 days. Coverage of sight deposits by secondary liquidity, i.e. Slovenian government securities and foreign marketable securities rated BBB or higher, declined by 5 percentage points in 2016 to 44%.

there is no guarantee of meeting the prudential requirements over the upcoming medium term of two to three years, having regard for the upcoming regulatory requirements (IFRS 9, MREL).

Compared with the Bank of Slovenia, the banks are more optimistic in their loan forecasts, and less optimistic with regard to their forecasts for deposits. The banks report their forecasts within the framework of their funding plans. In the most recent variant, the banks reported their forecasts for the period to 2018 on the basis of data available until the end of 2015. The figure below illustrates these forecasts compared with the Bank of Slovenia projections, the cut-off date for which was June 2016. The banks are forecasting a similar dynamic in total assets as the Bank of Slovenia. Growth is expected to be positive in 2017, and to strengthen further in the next year. Despite this similarity, the forecasts for the main categories on the asset and liability sides differ considerably. The banks are expecting relatively high positive growth in loans to the private non-banking sector already in 2016. Given the current year-on-year growth in loans, which stands at -3.1%, this is unlikely. By contrast, the banks are considerably more pessimistic with regard to deposits. They are forecasting a contraction in deposits by the private non-banking sector in 2016 and 2017, and weak growth in the next year. Growth in deposits by this sector stood at 6% in September 2016. The gaps between the forecasts for loans and deposits also lead to differences in other asset and liability items. On the asset side, the banks are forecasting a withdrawal from securities and greater focus on basic banking, in particular on the financing of SMEs and large enterprises. On the liability side, the comparison with the Bank of Slovenia is significantly more optimistic with regard to the acquisition of wholesale funding.

Figure 2.9: Comparison of Bank of Slovenia forecasts with bank forecasts for key balance sheet categories (left) and credit-to-GDP ratio (right), in percentages



Note: The trend is estimated with a recursive HP filter. The gap is the difference between the actual credit-to-GDP ratio, and the estimated long-term trend

Source: Bank of Slovenia

The credit-to-GDP gap will remain negative until 2018. The above right figure illustrates the gap calculated as the difference between the ratio of loans to the private non-banking sector to GDP and the long-term trend.[10] The series have been extended with forecasts to 2018, taking into account both, Bank of Slovena and bank projections. The dynamic of the gap has recently reversed, but it will remain sharply negative until 2018. The credit-to-GDP gap is one of the key indicators for triggering the counter-cyclical capital buffer. The negative forecasts indicate that there will be no need for a positive capital buffer for at least a few more years. Here it should be noted that this is just one in the set of indicators that the Bank of Slovenia monitors to determine the value of the counter-cyclical capital buffer.

2.2 Credit risk

Summary

The banks' activities to reduce credit risk have been reflected in a declining proportion of non-performing claims, to which the banks took an even more active approach in 2016. The activity has been reflected in more successful restructuring of claims as measured by the reoccurrence of arrears of more than 90 days, increased write-offs and collateral realisation, and the sale of non-performing portfolio to investors. In conjunction with the impact of the completion of the wind-down process at Factor banka and Probanka and their absorption by

[10] The long-term trend is estimated by means of a Hodrick-Prescott filter with a lambda parameter equal to 400,000. This is a recursive estimate, which in each period takes into account solely of the data available up to that point.

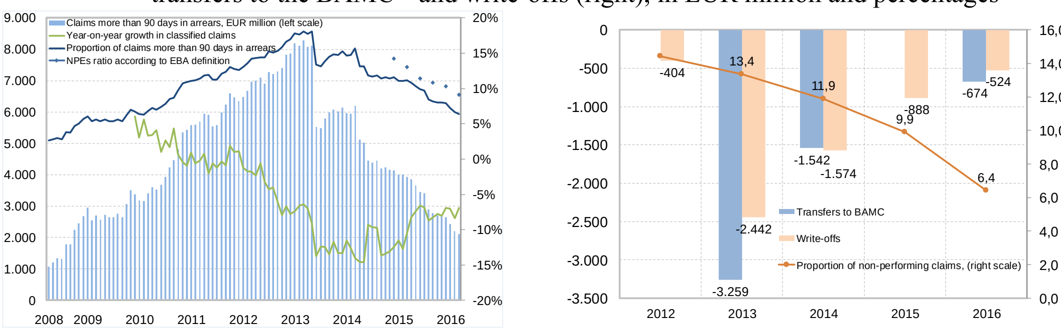
the BAMC, the proportion of claims more than 90 days in arrears had declined to 6.4% by September 2016, while the NPEs ratio according to the EBA's broader definition had declined to 9.1% by September, and was also displaying a trend of decline. The improvement in portfolio quality has been particularly evident in construction, followed by wholesale and retail trade, with more successful restructuring. Coverage by impairments and provisions also increased in 2016: the figure for Slovenia is now among the highest in the euro area. The ratio of unimpaired claims more than 90 days in arrears to capital declined. Despite the improvement in the credit portfolio, non-performing claims still represent a risk in combination with low bank profitability and the ongoing contraction in lending, which also entail a smaller inflow of new claims into better credit group. Despite the transition of existing non-performing claims to better credit rating group, the contraction in turnover means that the risk to healthy bank performance could again increase.

Quality of the credit portfolios of banks and savings banks

The improvement in the quality of the banks' credit portfolio continued in 2016. The year saw a more active approach to the resolution of the banking system. The orderly wind-down of Factor banka and Probanka was completed in February with the withdrawal of their operating licences. Claims more than 90 days in arrears were reduced by EUR 0.5 billion upon absorption into the BAMC, which was a key factor in the improvement of the portfolio in the first quarter. In addition, the banks' activities to reduce credit risk via restructuring, increased write-offs of non-performing claims and the sale of non-performing portfolio have been reflected in a declining proportion of non-performing claims. There was major consolidation of the banking system in 2016: PBS was taken over by NKBM, now a bank under majority foreign ownership, in September.

The proportion of claims more than 90 days in arrears declined sharply in 2016, reaching 6.4% of classified claims in September. The figure has declined by 11.7 percentage points since the beginning of the recovery of the banking system in November 2013, which is a positive signal of the reduced burden placed on bank balance sheets by claims more than 90 days in arrears. Claims more than 90 days in arrears amounted to EUR 2.1 billion in September, or 5.3% of GDP, compared with a figure of 22.8% in November 2013. According to the transition matrices, claims at banks were upgraded from lower to higher rating pools in significantly greater amounts than in previous years, with the exception of claims against households.[11] In the wake of the anticipated continuing economic growth, bank portfolios can be expected to continue improving.

Figure 2.10: Growth in classified claims and claims more than 90 days in arrears (left), and transfers to the BAMC[12] and write-offs (right), in EUR million and percentages



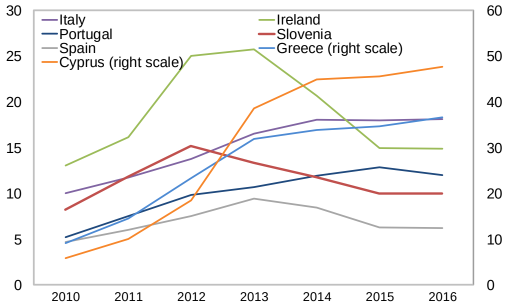
Source: Bank of Slovenia

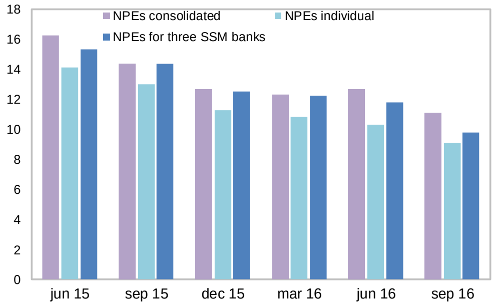
Portfolio quality in the Slovenian banking system as measured by the proportion of non-performing claims is still among the worst in the euro area, albeit with a notable trend of improvement. According to IMF data,[13] which provides longer data series than other sources, six

[11] Bank of Slovenia survey, March 2016.
[12] Performing claims against affiliates of clients with non-performing claims were also transferred to the BAMC.
[13] Data is submitted by national supervisors. Loans or broadly defined claims more than 90 days in arrears are reported as NPLs. In addition, these include claims where the payment of interest over a 90-day timetable is added to the principal, claims being refinanced and claims where the repayment deadline is extended. Claims that are not more than 90 days in arrears, but show soft signs of being non-performing according to the definition of the national supervisor, e.g. the initiation of bankruptcy, are also reported as NPLs. The euro area members as at 2015 (19 countries) are included in all periods of the illustration.

countries in the euro area have a higher figure than Slovenia for the proportion of non-performing claims. Only in three of these has there been an improvement in portfolio quality in recent years.

Figure 2.11: NPL ratio (according to the IMF definition) by country (left), and NPEs (according to the EBA definition) for Slovenia (right), in percentages





Sources: IMF, Bank of Slovenia

The figures according to the EBA methodology indicate increased credit risk and a weaker position relative to other euro area countries.[14] Under the broader capture of non-performing exposures, the indicators according to the EBA definition[15] also show a decline in the credit risk of the banks' portfolio. Non-performing exposures amounted to EUR 3.7 billion in September 2016, or 9.1% of the banks' total exposure. The year-on-year decline of EUR 1.7 billion was the result of a contraction in loans and other financial instruments, forbearance having reduced claims by EUR 0.7 billion.

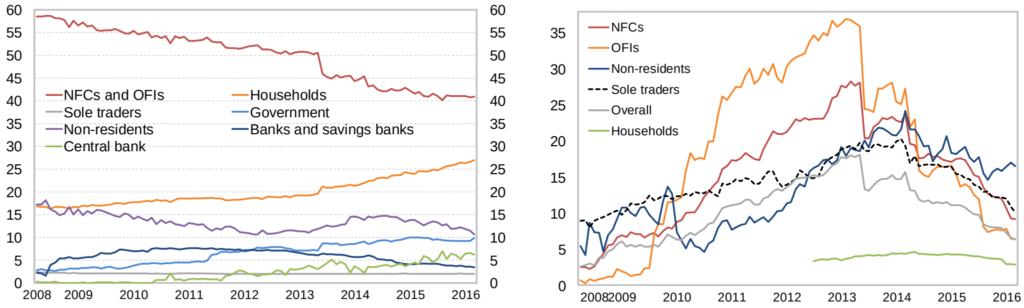
A comparison with other euro area countries according to the EBA methodology is only possible at the consolidated level. This also takes account of the exposures of banks established in Slovenia and subsidiary operations in the rest of the world. In the case of the Slovenian banking system, this primarily entails an increase as a result of exposures to the countries of south-eastern Europe. At the same time these banks are also most exposed to the aforementioned grouping of countries. In the comparison of Slovenia with other euro area countries according to the EBA methodology, Slovenia is ranked similarly to the comparisons at the IMF, albeit at a slightly higher level.[16]

[14] In international comparisons the EBA and other ECB bodies frequently illustrate Slovenia solely through its SSM banks (the three largest banks alone), which ranks it significantly higher on the list of euro area countries.

[15] The EBA has set out a standardised definition of non-performing exposures for the purpose of transparency within the EU. The definition is broader than the current published definition of claims more than 90 days in arrears, as it also includes exposures that meet the unlikeliness to pay criterion. According to the EBA methodology, the category also includes certain forborne exposures or claims in respect of which there has been a change in repayment terms owing to the client's financial difficulties. An observation period is also established for forborne exposures, which means the claims are maintained as non-performing for a certain time after the beginning of their regular repayment.
In addition to the expanded capture of non-performing claims, primarily including forborne claims, there is also an expansion in the denominator of the indicator, which, alongside the existing financial assets measured at amortised cost (loans and debt securities) and commitments given under off-balance-sheet items, also includes available-for-sale financial assets, financial assets designated at fair value, and approved undrawn loans. According to the data available as at 30 September 2016, this entails an expansion of the previous numerator of claims more than 90 days in arrears in the amount of EUR 2.1 billion to the EBA definition of non-performing exposures in the amount of EUR 3.7 billion.

[16] The data source is the CBD (consolidated banking data) database at the ECB. Only data at the consolidated level is available for other countries. In Slovenia the database only includes FINREP reporters: systemically important banks and less significant banks, if they report on a consolidated basis (savings banks and Gorenjska banka, for example, are excluded).

Figure 2.12: Breakdown of banks' classified claims (left) and proportion more than 90 days in arrears (right) by customer segment



Source: Bank of Slovenia

Non-financial corporations still account for the majority of the banks' claims more than 90 days in arrears, although both the stock and proportion of claims within the aforementioned sector have fallen to the level recorded in 2010. At the same time active firms have reduced their indebtedness over recent years to close to the pre-crisis level, an indication that the difficulties faced by active firms in servicing debt are diminishing. The proportion of claims more than 90 days in arrears in the non-financial corporations sector has been declining consistently since the third quarter of 2014, and was significantly reduced in 2016 by two events: first, during the absorption of Factor banka and Probanka into the BAMC in February, and second, with the sale of part of the banks' portfolio to investors in the third quarter. Claims against non-financial corporations more than 90 days in arrears amounted to EUR 1.2 billion in September 2016, or 9.2% of classified claims in this sector.

The sale of part of the portfolio reduced the proportion of claims more than 90 days in arrears in the household sector by 28% in 2016. Claims more than 90 days in arrears amounted to EUR 250 million, or 2.8% of the classified claims in this sector. The burden on the household sector, which throughout the period of the financial crisis was the least problematic sector in the banks' credit portfolio, thereby declined below its level at the time of the initial reporting in 2013, when it stood at 3.4% of the portfolio.

Exposures to non-residents accounted for 11% of the banks' credit portfolio in September 2016, this portfolio segment having contracted by EUR 1.2 billion in 2016. The decline in claims more than 90 days in arrears was slower than the decline in exposures to non-residents, for which reason the sector remains the most heavily burdened by claims more than 90 days in arrears, despite their small size in absolute terms. While it was primarily the large domestic banks that reduced their claims against non-residents more than 90 days in arrears in 2015, the largest contribution in 2016 came from the exclusion of claims at Factor banka and Probanka.Claims against non-residents more than 90 days in arrears amounted to EUR 577 million in September 2016, or 16.5% of the classified claims in the sector. Non-residents account for 27% of total claims more than 90 days in arrears.

Classified claims against non-financial corporations more than 90 days in arrears

SMEs account for the majority of claims more than 90 days in arrears: their proportion stood at 41% in October, which means that this corporate segment remains a heavy burden on bank balance sheets. However, in the reduction of claims against non-financial corporations more than 90 days in arrears there was significant evidence of a decline in claims against SMEs in 2016, for the first time since the outbreak of the financial crisis. Claims against SMEs declined by EUR 314 million in the third quarter alone to EUR 867 million. Claims more than 90 days in arrears in this corporate segment hit the level of 15.9% for the first time since the beginning of 2011. The decline in the proportion of claims against large enterprises was also attributable to the sale of corporate assets within the framework of MRAs and the sale of part of the portfolio to investors in 2015. Claims more than 90 days in arrears accounted for 4% of classified claims against large enterprises in September 2016.

The transition matrices for the credit portfolio show a greater improvement in the quality of the SMEs portfolio. The pace of transitions between ratings is analysed by means of transition matrices calculated separately for SMEs and large enterprises, on the basis of the number of transitions of firms. The pace of transitions during the 12 months to September 2016 is compared with that of the corresponding period a year earlier. Downgradings are slowing for SMEs, while upgradings are increasing for both corporate segments. The most evident increase in upgradings is for D-rated SMEs, where 8.4% of D-rated customers were upgraded in this year's matrix, compared with 4.2% in the previous year. A slightly lower rate of upgradings, albeit with a clear trend of improvement, is evident for large enterprises.

Table 2.1: Proportion of transitions of SMEs and large enterprises between ratings, taking into account the number of customers, in percentages

Micro, small and medium-size enterprises (SMI

		Sep 2015							Sep 2016				
		A	B	C	D	E			A	B	C	D	E
Sep 2014	A	80,3	15,6	2,5	1,2	0,4	Sep 2015	A	84,0	13,0	2,1	0,9	0,1
	B	14,2	69,8	12,0	3,4	0,7		B	18,8	70,7	8,4	2,0	0,3
	C	3,5	16,4	58,5	17,5	4,1		C	5,7	19,6	65,8	7,1	1,8
	D	0,3	1,9	2,0	65,2	30,5		D	0,5	2,0	5,9	62,2	29,4
	E	0,0	0,1	0,1	1,6	98,2		E	0,2	0,1	0,4	2,0	97,4

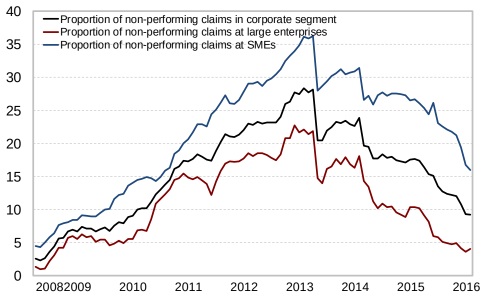
Large enterprises

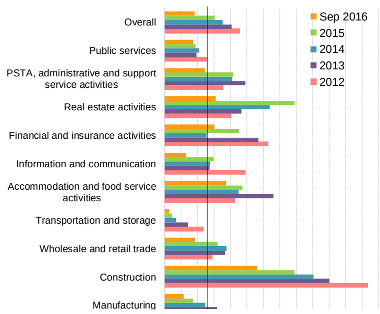
		Sep 2015							Sep 2016				
		A	B	C	D	E			A	B	C	D	E
Sep 2014	A	92,3	5,3	1,6	0,7	0,1	Sep 2015	A	92,9	5,9	0,9	0,3	0,0
	B	15,2	73,5	7,1	4,2	0,0		B	13,2	77,8	9,1	0,0	0,0
	C	1,1	7,5	70,6	18,2	2,7		C	1,5	29,0	64,1	5,3	0,0
	D	0,0	0,8	4,6	82,6	12,0		D	3,0	4,7	9,5	74,6	8,3
	E	0,0	0,0	1,9	5,7	92,4		E	0,0	0,0	1,0	3,9	95,1

Source: Bank of Slovenia

The quality of the credit portfolio of non-financial corporations improved significantly in 2016, which was also reflected in the most heavily burdened sectors. The largest improvement in 2016 was recorded by the construction portfolio, where there has been the most evident decline in the stock and proportion of claims more than 90 days in arrears since the beginning of the recovery of the banking system in 2013. Despite a decline of 37.2 percentage points in the proportion since the end of November 2013, 11.7 percentage points of which was in 2016, the figure in the construction sector remains well above the average for non-financial corporations at 28.1% of classified claims. The relative importance of this sector is also evidenced in the high proportion of all claims against non-financial corporations more than 90 days in arrears that it accounts for: 27.5%.

Figure 2.13: Proportion of claims more than 90 days in arrears by corporate size (left), and proportion of claims against non-financial corporations more than 90 days in arrears by sector (right), in percentages





Source: Bank of Slovenia

A notable improvement was also recorded by manufacturing, where the trend of decline in claims more than 90 days in arrears continued. The proportion of claims more than 90 days in arrears in the manufacturing sector was down 16.4 percentage points on the beginning of the recovery of the banking system in November 2013, at 5.9%. Favourable economic growth was expressed in improved profitability in the corporate sector, and increased debt servicing capacity, which made a positive contribution to the improvement in the quality of this segment of the banking portfolio. The proportion of total claims against non-financial corporations more than 90 days in arrears accounted for by the manufacturing sector nevertheless remains high, owing to the relatively large size of the sector, and the larger decline in arrears in other sectors where the burden is heavier. Manufacturing accounted for 17.4% of all claims against non-financial corporations more than 90 days in arrears in September, and for 27.4% of all classified claims against non-financial corporations.

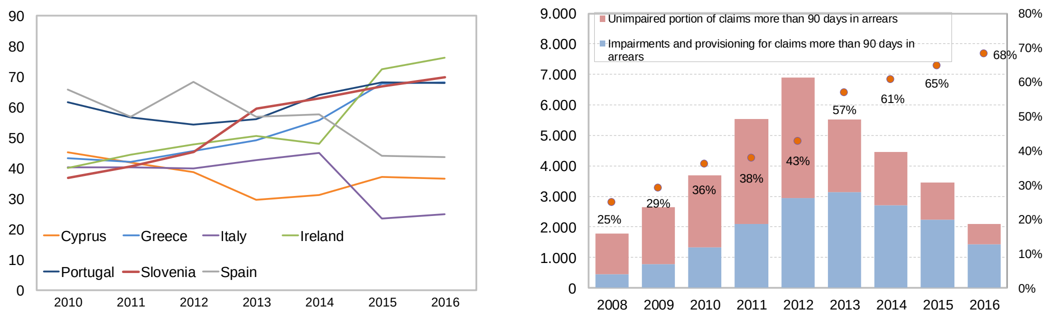
Coverage of claims more than 90 days in arrears by impairments and provisions, capital and collateral

Coverage by impairments and provisions in Slovenia is higher than the euro area average. It has risen continually since the beginning of the recovery of the banking system, and is among the highest of the euro area countries. Ireland was notable for the highest coverage in 2016, having reduced its NPL ratio. Coverage in Greece is still increasing sharply, but in contrast to Slovenia and Ireland it still has a trend of increase in the NPL ratio, which is indicative of the need for additional impairments.

The banks have increased coverage of claims more than 90 days in arrears by impairments and provisions since the outbreak of the financial crisis, and it rose further in 2016. Coverage of claims more than 90 days in arrears stood at 68.1% in September 2016, 19.7 percentage points more than before the first transfer to the BAMC in November 2013. Impairments and provisions were down 36% on the end of 2015, as a result of increased write-offs of claims and the sale of part of the portfolio to investors (with a significant impact in the third quarter of the year), which had the highest coverage by impairments. Impairments were also released at the same time as a result of the improvement in portfolio quality. The new international financial reporting standards, namely IFRS 9, which is effective as of 2018, are also expected to have an impact on the stock of impairments.

Coverage of non-performing exposures by impairments and provisions according to the EBA definition also increased. Coverage of exposures amounted to 58% in September 2016, up 7.5 percentage points on June 2015; the coverage of restructured claims, which accounted for half of non-performing exposures in September, was below-average, at 53%.

Figure 2.14: Coverage of claims more than 90 days in arrears by impairments and provisions compared with other countries (left) and in the Slovenian banking system (right)

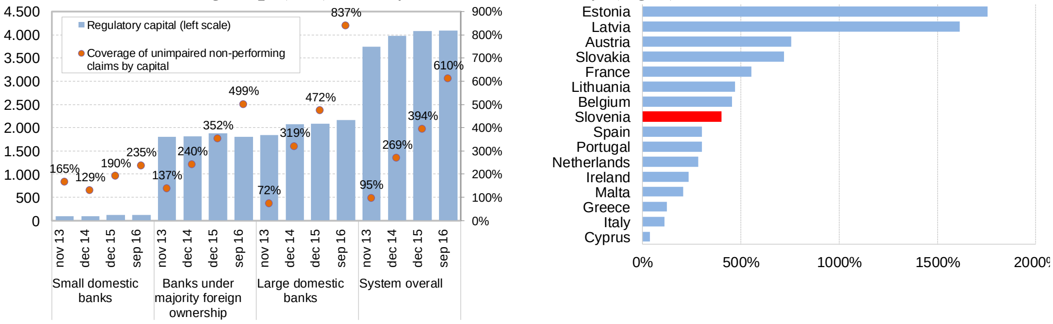


Sources: Bank of Slovenia, IMF

The highest coverage of claims more than 90 days in arrears by impairments and provisions was recorded by the household sector, where the figure stood at 79.9% in September. However, given the small size of the portfolio of claims more than 90 days in arrears, the change in impairments and provisions is less significant in its impact on the trend in coverage of total claims more than 90 days in arrears by impairments and provisions. Impairments and provisions for non-residents, which account for a third of the total, have a stronger impact on overall coverage by impairments. Since jumping by 20 percentage points on the previous month in December 2013, coverage of claims against non-residents more than 90 days in arrears has gradually increased, reaching 75.9% in September 2016.

The corporate sector accounts for half of the impairments and provisions for claims more than 90 days in arrears. The two main factors in the decline in impairments on corporate claims were the absorption of Factor bank's and Probanka's portfolio by the BAMC, and the sale of part of the non-performing portfolio to investors. However, coverage in the corporate segment was up 2 percentage points on the end of 2015, as a result of the simultaneous larger decline in claims more than 90 days in arrears. It nevertheless remains below the average across the entire portfolio, and stood at 62.3% in September. The sole traders segment also has below-average coverage of claims more than 90 days in arrears: the figure stood at 58.2% in September.

Figure 2.15: Coverage of unimpaired portion of claims more than 90 days in arrears by capital by bank group (left) and by euro area country (right)



Sources: Bank of Slovenia, IMF

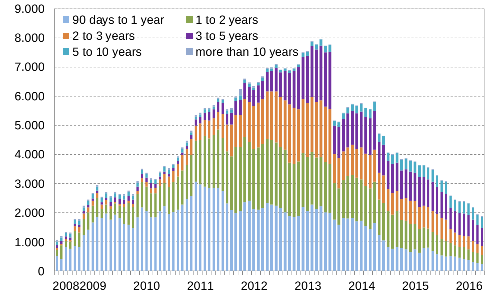
Comparing the situation before and after the recapitalisations, at the large domestic banks there has been a notable increase in coverage of the unimpaired portion of claims more than 90 days in arrears by regulatory capital. In addition to the capital injection, in the past this indicator also reflected the effect of the transfer of non-performing claims to the BAMC. The further improvement in coverage by capital in 2016 was partly attributable to an improvement in portfolio quality and an increase in coverage by impairments, and partly attributable to an increase in capital and the rise in the banking system's capital adequacy. Coverage of the unimpaired portion of claims more than 90 days in arrears by capital reached 610% in the third quarter of 2016. Slovenia is ranked in the middle of the euro area countries in terms of coverage by impairments and provisions and in terms of coverage by capital.

Resolution of claims more than 90 days in arrears

The proportion of the balance sheet accounted for by non-performing claims increased as a result of the contraction in the banking portfolio during the financial crisis and the inability to expand turnover to new customers, which would have balanced the balance sheet. This had consequences for the burden on the banks' capital and for their profitability.

A more active approach by the banks also slowed the lengthening of the maturity of claims in arrears. Arrears of more than five years accounted for 20% of claims more than 90 days in arrears in September 2016. The proportion of claims more than five years in arrears had increased, albeit as a result of the resolution of claims in arrears of lower maturities, which were down significantly among claims in arrears. The retention in the portfolio of the debtors with the longest arrears is an indication that in the resolution of non-performing claims there are delays in addressing that part of the portfolio where there are probably few if any firms with good prospects that it is reasonable to restructure, or that the banks are waiting for the conclusion of court proceedings.

Figure 2.16: Percentage breakdown of claims more than 90 days in arrears



Source: Bank of Slovenia

In the spring survey the banks assessed that they expected to pursue the resolution of non-performing claims primarily through further restructuring. They actually exceeded their forecast reduction in non-performing claims of one quarter relative to the end of 2015. They emphasised that the reduction would be achieved through restructuring, which proved particularly successful for corporates, through write-offs and through the realisation of collateral.

The banks are providing for the restructuring of claims for customers facing financial difficulties, even independently of MRAs, most often via the extension of the maturity of the loan agreement or the deferral of repayments. Restructured claims amounted to EUR 2.6 billion in September 2016. An improvement in the success of restructuring is indicated in 2016: only a quarter of claims have again fallen more than 90 days in arrears, compared with 35% in the same period of the previous year. The corporate sector accounts for EUR 1.9 billion of the restructured claims, half of which are in the sectors of wholesale and retail trade and manufacturing (see table below). The stock and proportion of claims under restructuring are simultaneously declining in the corporate sector. The proportion of restructured claims again falling more than 90 days in arrears was down 9.5 percentage points on the end of 2015, most of the decline occurring in the third quarter. Of the sectors with the largest amount of restructuring, the success of restructuring as measured by the proportion of restructured claims that again fall more than 90 days in arrears was highest in the wholesale and retail trade sector, where the figure was 12.7%. It was significantly worse in the construction sector, where 33.8% of restructured claims again fall more than 90 days in arrears.

Table 2.2: Classified claims under restructuring and restructured claims more than 90 days in arrears against non-financial corporations by sector, in EUR million and percentages

	Classified claims in restructuring			Proportion of classified claims in restructuring			Restructured claims more than 90 days in arrears			Proportion of restructured claims more than 90 days in arrears		
	dec 14	dec 15	sep 16	dec 14	dec 15	sep 16	dec 14	dec 15	sep 16	dec 14	dec 15	sep 16
Agriculture, forestry, mining	62	66	44	31,9	35,1	27,5	8	12	9	12,7	17,6	19,8
Manufacturing	880	604	416	23,0	17,0	12,1	150	81	60	17,0	13,4	14,5
Electricity, gas, water, remediation	43	17	13	4,0	1,6	1,3	40	9	8	91,8	49,8	60,4
Construction	210	164	114	14,7	12,4	10,1	96	84	38	46,0	51,2	33,8
Wholesale and retail trade	688	630	534	26,7	25,0	23,1	187	164	68	27,2	26,1	12,7
Transportation and storage	118	111	106	7,5	6,3	6,6	5	5	8	4,1	4,1	7,9
Accommodation and food service	166	146	120	42,5	38,7	36,3	40	42	30	24,3	28,9	24,6
Information and communication	69	55	41	15,1	15,0	7,0	43	38	30	62,1	69,7	73,2
Financial and insurance activities	142	97	55	58,5	53,0	56,2	18	16	5	12,3	16,0	9,0
Real estate activities	301	309	261	40,0	43,3	43,5	99	160	35	33,0	51,9	13,6
PSTA, administrative, support	250	149	114	21,8	13,3	11,4	73	67	51	29,1	45,2	44,8
Public services	88	103	89	28,2	35,5	31,7	13	12	12	15,1	11,8	13,8
Non-financial corporations overall	3.018	2.452	1.906	21,6	18,1	15,2	772	690	355	25,6	28,1	18,6
All restructured claims	**4.046**	**3.339**	**2.599**	**14,1**	**12,8**	**10,9**	**1.287**	**1.062**	**641**	**31,8**	**31,8**	**24,7**

Source: Bank of Slovenia

The banks' resolution and clean-up of their balance sheets via write-offs[17] was encouraged by the guidelines for the management of non-performing claims against SMEs. The banks wrote off EUR 524 million of claims over the first nine months of 2016, double the amount of EUR 275 million forecast for the whole year in the spring survey. More write-offs are expected in the final quarter of the year.

Collateralisation of claims

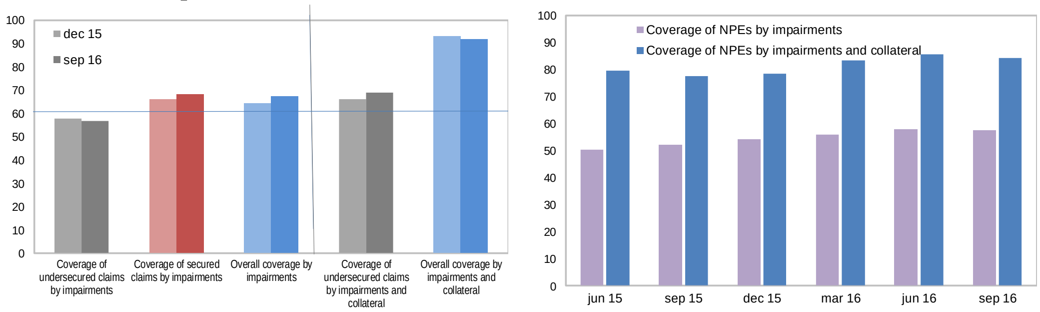
The banks increased coverage of claims more than 90 days in arrears by impairments and provisions and by collateral in 2016. Secured claims[18] more than 90 days in arrears have a higher coverage by impairments, whereby the banks are creating a safety reserve in the event of revaluation or collateral realisation that would not cover the entire claim. In terms of value, the collateral for such claims strongly exceeds the claims for which it has been pledged. In the wake of a fall in collateral value, the banks would therefore not require as much coverage by impairments,

[17] In light of the amendments to the Regulation on the assessment of credit risk losses (Official Gazette of the Republic of Slovenia, Nos. 29/12 and 12/14), the banks are writing off unsecured claims against debtors more than one year in arrears or in bankruptcy proceedings, and claims secured by real estate collateral more than four years in arrears or for which the bank in question did not receive any payment from the realisation of collateral over the same period.

[18] The definition of secured claims covers claims where the total value of the collateral is equal to or higher than the amount of the secured claim after impairments (the net claim), while under-secured claims are those claims where the total amount of collateral fails to reach the exposure level of the net claim. The value of the collateral takes account of the reported fair value, excluding negative revaluations. Claims against households and certain other claims are not captured in full in the credit portfolio.

which could result in the release of impairments in the wake of the successful realisation of collateral. Coverage of secured claims by impairments increased by 2.1 percentage points over the first nine months of the year to 68.2%. Coverage by impairments in the category of claims that do not achieve full coverage by impairments and collateral stood at 57% in September 2016, while coverage by impairments and collateral together stood at 68%. Claims of this type accounted for 26% of claims more than 90 days in arrears in September 2016, an increase of 6 percentage points on the end of 2015. Coverage of all claims, both secured and under-secured, declined somewhat to stand at 91.9% in September 2016, taking account of collateral received up to the amount of the net claim more than 90 days in arrears and impairments.

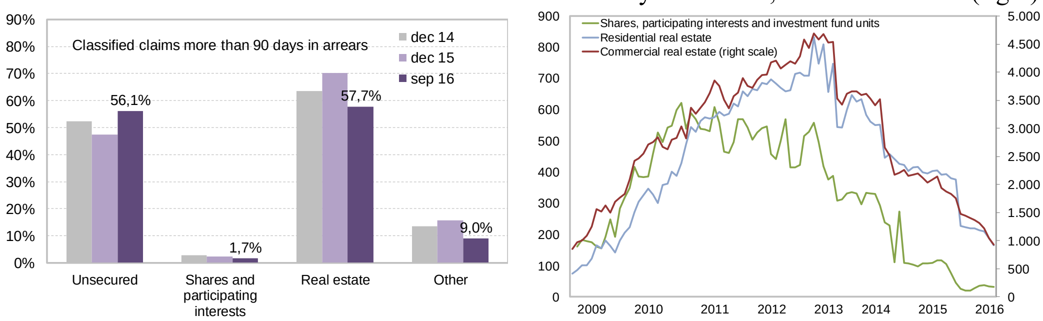
Figure 2.17: Coverage of claims more than 90 days in arrears (left) and NPEs (right) by impairments and collateral



Source: Bank of Slovenia

The proportion of unsecured claims more than 90 days in arrears increased in 2016. Real estate, in particular commercial real estate, remains the most common form of collateral in terms of value. However, as a result of developments on the market, where according to SMARS data there was a major shift from sales to leasing, the value of collateral in the form of commercial real estate also declined, and almost reached the level of residential real estate in 2016. Collateral of this type was also the most commonly realised in 2015, according to the survey.

Figure 2.18: Proportion of claims more than 90 days in arrears by type of collateral (left), and value of collateral for claims more than 90 days in arrears,[19] in EUR million (right)



Source: Bank of Slovenia

Box 3: Current developments in the resolution of NPLs

ECB guidance for the management of NPLs of systemically important banks

The supervisory board of the Single Supervisory Mechanism (SSM) extended the mandate of ECB task force for NPLs to 30 June 2017. The tasks of the task force encompass analysis of the infrastructure in connection with NPLs in all the countries of the SSM (in its work to date the ECB has prepared a review of eight countries, including Slovenia).

A public discussion on the ECB guidance was held between 12 September and 15 November 2016. The Bank of Slovenia prepared a presentation on the guidance and the most significant challenges faced by Slovenian banks for the members of the BAS's risk committee. The Bank of Slovenia called on the BAS's representatives to submit their commentary.

The final version of the guidance will be drafted by the ECB task force after the conclusion of the public discussion for adoption at the meeting of the SSM's supervisory board. Banks are expected to be issued with the guidance in February or March 2017. The ECB guidance is aimed at the activities of systemically important banks in the SSM.

The ECB will also organise training for members of joint supervisory teams (JSTs) in all activities.

On the basis of analysis of the gaps between the ECB guidance and the current arrangements for the management of NPLs in Slovenia, the Bank of Slovenia took the decision that, in light of the principle of proportionality, the application of the guidance to less significant banks in Slovenia is also reasonable.

Slovenian less significant banks will be required to fully adapt their activity in the aforementioned area as of 1 January 2018.

Preparation of the manual for the management of NPLs of MSMEs

On the basis of an agreement on technical assistance from the European Commission for the management of NPLs of micro, small and medium-size enterprises (MSMEs), activities are underway to issue a manual. The manual will entail the operational implementation of the BAS guidelines for the management of NPLs of MSMEs, and will be harmonised with the requirements of the ECB guidance.

The primary driver of the activity in collaboration with the Bank of Slovenia is the World Bank.

A working visit by World Bank representatives in late September and early October 2016 was devoted to dialogue with the Bank of Slovenia to provide a detailed definition of the requirements and the structure of the manual for the management of NPLs of MSMEs. The first working version of the manual contains guidance for the segmentation of the MSMEs portfolio, indicators for assessing borrower viability, practical examples and drafts of legal documents.

The next steps before its application comprise:

- a review of the first version of the manual at the Bank of Slovenia, and coordination of criticism and remarks with the World Bank by the end of 2016;
- a workshop under the aegis of the BAS for commercial banks in January 2017;
- projected release of the manual by the end of January 2017.

Supervisory dialogue with banks in connection with NPLs

The Bank of Slovenia held meetings with representatives of eight banks between May and mid-December 2016. The themes of the meetings were an assessment of the banks' compliance with the Bank of Slovenia guidance for the management of NPLs, an assessment of the NPL strategy at each bank, a review of the realisation of the individual plan for the reduction of NPLs and a comparison of NPL indicators with the average across the banking system.

2.3 Income statement and income risk

Summary

The improvement in bank profitability continued in 2016. The banks continued to record positive performance over the first three quarters of 2016, generating a pre-tax profit of EUR 334 million. The key factors were the decline in credit risk and the sharp reduction in impairment and provisioning costs under the influence of the improved economic situation, and the banks' increased activity in resolving non-performing claims. The banking system actually recorded a net release of impairments over the first eight months of the year. The banks also generated relatively solid non-interest income over the first three quarters of the year, thereby keeping gross income comparable to the previous year.

However, the banks are continuing to see a decline in net interest income, at an undiminished pace of around 10% in year-on-year terms. The decline is attributable to the contraction in loans, the fall in lending rates and the fall in returns on securities. The banks' interest expenses are continuing to decline, but given that the proportion of funding accounted for by sight deposits by the non-banking sector is at a historically high level, and the level of interest rates is at a record low, the manoeuvring room for generating higher net interest income is more and more limited.

The trend of decline in the net interest margin has continued, although the decline has slowed, as the banks' interest-bearing assets are also declining. The as-yet very moderate decline in the net interest margin is primarily attributable to price factors. Given the limited possibilities of improving cost-efficiency, unless they begin to increase their lending activity the banks will be exposed to increased income risk, even over the medium term.

Operating result and income risk

The banks recorded a pre-tax profit of EUR 334 million over the first nine months of 2016. Net interest income continued to decline, and was down approximately 10% in year-on-year terms over the first nine months of the year. There was a sharp decline in both interest income and interest expenses. The banks succeeded in maintaining their gross income at a comparable level to the previous year, thanks to relatively solid growth in non-interest income. The increase in non-interest income was attributable to a positive result in trading, i.e. the realised capital gains. The proportion of the banks' gross income accounted for by net interest over the first nine months of the year stood at 59%, below the long-term average. Impairment and provisioning costs were extremely low during this period, having accounted for less than 5% of the total gross income.

Table 2.3: Banking sector income statement

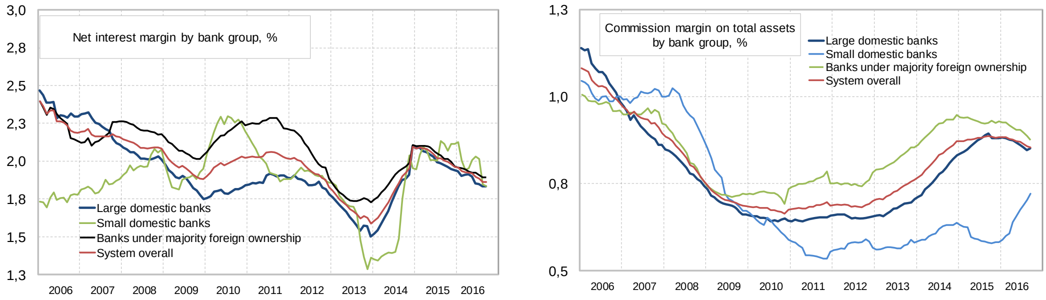
	Amount, EUR million				Growth, %				Ratio to gross income, %			
	2013	2014	2015	Sep 16	2013	2014	2015	Sep 16	2013	2014	2015	Sep 16
Net interest income	708	832	746	507	-20,1	17,5	-10,4	-9,6	64,9	67,6	64,4	58,7
Non-interest income	383	399	412	356	-43,6	4,1	3,3	21,9	35,1	32,4	35,6	41,3
of which fees and commission	339	346	336	235	0,0	2,0	-3,0	-7,3	31,1	28,1	29,0	27,2
of which net gain/loss on financial assets and liabilities held for trading	-3	7	-12	8	…	…	…	…	-0,3	0,6	-1,0	0,9
Gross income	1091	1231	1158	863	-30,3	12,8	-6,0	1,2	100	100	100	100
Operating costs	721	687	686	490	-2,9	-4,7	-0,1	-1,8	66,1	55,8	59,3	56,7
labour costs	384	367	368	273	-3,8	-4,6	0,5	0,0	35,2	29,8	31,8	31,6
Net income	370	544	472	373	-55,0	47,0	-13,3	5,4	33,9	44,2	40,7	43,3
net impairments and provisioni	3809	650	313	39	138,1	-82,9	-51,8	-74,9	349,1	52,8	27,1	4,6
of which at amortised cost	2903	524	222	5	141,8	-81,9	-57,7	-94,8	266,1	42,6	19,2	0,6
Pre-tax profit	-3439	-106	158	334	-342,9	96,9	249,2	69,3	-315,2	-8,6	13,7	38,7
corporate income tax	-147	-8	-43	-43	…	…	…	…	-13,4	-0,6	-3,7	-5,0
Net profit	-3586	-114	115	291	-375,5	96,8	201,1	78,6	-328,6	-9,3	10,0	33,7

Source: Bank of Slovenia

1) Net interest margin and non-interest margin in the banking system

The very gradual trend of decline in the net interest margin continued. The non-interest margin increased in 2016, although the component of the margin deriving from the most stable income, namely for fees and commission, is not increasing. The net interest margin on interest-bearing assets over the first nine months of 2016 fell below 2%. The figures are relatively equal across the individual bank groups. They ranged from 1.93% to 1.99% at the end of September, calculated on the basis of the preceding 12 months. The net non-interest margin increased as a result of the increase in non-interest income: it stood at 1.28% at the end of September, down just under 0.3 percentage points on the end of 2015. The small domestic banks operated with a slightly lower non-interest margin (1.13%) than the large domestic banks (1.27%) and the banks under majority foreign ownership (1.31%). The rise in the non-interest margin is primarily the result of the aforementioned one-off factors in non-interest income. The ongoing decline in total assets was also a factor in its rise.

Figure 2.19: Net interest margin (left), and "commission" margin on total assets (right) by bank group, in percentages



Note: In light of the relatively large fluctuation in non-interest income attributable to certain one-off developments in previous years, only the commission margin is illustrated: fees and "commissions" accounted for more than 80% of all non-interest income in 2014 and 2015, compared with two-thirds over the first nine months of 2016.
Source: Bank of Slovenia

Although non-interest income increased in 2016, its most stable component, fees and commissions, has continued to decline. The banks therefore did not compensate for the decline in net interest income with more sustainable forms of non-interest income. The contraction in lending activity is also bringing a decline in the banks' income tied to their lending activity. Only by gradually increasing lending activity can the banks expect positive growth in their net non-interest income that derives from various fees and commissions.

1a) Decomposition of net interest income (NII) and the net interest margin (NIM)

Net interest income is the most important component of the banks' gross income. In years when there are no major fluctuations in non-interest income, it accounts for around two-thirds of gross income. Since 2008 the banks have faced a decline in interest income and interest expenses, and a reduction in turnover. In 2008 the banks realised EUR 2.6 billion of interest income and EUR 1.7 billion of interest expenses, giving a net interest income of just under EUR 1 billion. Compared with 2010, when the banks generated their highest net interest income[20] since joining the EU, in the amount of EUR 1.05 billion, in September 2016[21] interest income was down 58%, interest expenses were down 82%, net interest was down 34% and average total assets were down 28%.

The decomposition of net interest income allows for the measurement of the relative importance of changes in individual components of interest income and expenses to the overall change in net interest. Changes in net interest income are illustrated below in terms of their nominal amount in millions of euros, and in relative terms, i.e. with regard to interest-bearing assets (the net interest margin).[22] The left figure below illustrates price effects and quantity effects on the change in net interest income,[23] while the right figure illustrates the contributions made by interest-bearing assets and interest-bearing liabilities to the change in NIM.[24]

Price factors have prevailed over quantity factors since the outbreak of the financial crisis. The importance of changes in quantity and price (effective interest rate) can be evaluated for each of the components, namely interest income and interest expenses. It can thus be determined whether the decline/increase in net interest income is more attributable to changes in interest rates

[20] Interest income and interest expenses have been declining since 2009, as a result of the contraction in activity and the fall in interest rates.
[21] For the sake of comparability with previous years, the figures for September 2016 capture the preceding 12 months, using monthly sums for the income categories, and the average over 12 months for total assets.
[22] For a comparison with the two methods cited here, see for example the decomposition of net interest margin for Slovenia according to the DuPont method, on page 73 of the June 2016 Financial Stability Review.
[23] See http://www.boi.org.il/en/NewsAndPublications/RegularPublications/Banking%20Supervision/HalfYearReports/HalfYear2015/table6.pdf (Bank of Israel).
[24] The figure illustrates the overall contribution of interest-bearing asset instruments and interest-bearing liability instruments. The contributions can also be itemised more accurately by instruments (see Figure 2.21a). In addition individual instruments can be itemised in terms of their yields / effective costs and their shares, to determine how the change in the net interest margin is affected by changes in yields and effective costs (the yield/cost effect) with regard to the individual type of interest-bearing asset (loans, securities, other assets) or interest-bearing liability (deposits by the non-banking sector, wholesale funding, other liabilities), and how it is affected by changes in the composition of investments and bank funding (the share effect). For more, see Covas, Rezende and Vojtech (2015). Why Are NIMs of Large Banks So Compressed? <https://www.federalreserve.gov/econresdata/notes/feds-notes/2015/why-are-net-interest-margins-of-large-banks-so-compressed-20151005.html> (27 June 2016).

(prices) or changes in quantities on bank balance sheets. The increase in lending meant that quantity effects prevailed over price effects before the outbreak of the crisis. During this period, in the context of the increased competition on the banking market, there was a clear trend of decline in the net interest margin, although net interest income was nevertheless increasing as a result of the growth in turnover. By contrast, price effects have prevailed over quantity effects since the outbreak of the financial crisis.

The decline in interest income exceeded the decline in interest expenses in 2015 and 2016. The decline in net interest was primarily attributable to price effects. Even in 2014 net interest income increased slightly, although price effects were prevailing over quantity effects at that time. The fall in liability interest rates and the rapid increase in the proportion of sight deposits were particularly important factors. However, the changes in the aforementioned year should be treated with a certain measure of reserve, owing to their coincidence with changes in the structure of the balance sheets of certain banks because of recovery measures. Net interest income has had a negative year-on-year growth by around 10% in each of the last two years. Despite the decline in turnover, price effects were prevalent.

Figure 2.20: Contribution to change in net interest income made by quantity and price factors, in EUR million, and change in net interest margin, in percentages (left), and overall contributions made by interest-bearing assets and interest-bearing liabilities to changes in net interest margin in the Slovenian banking system, in percentage points (right)

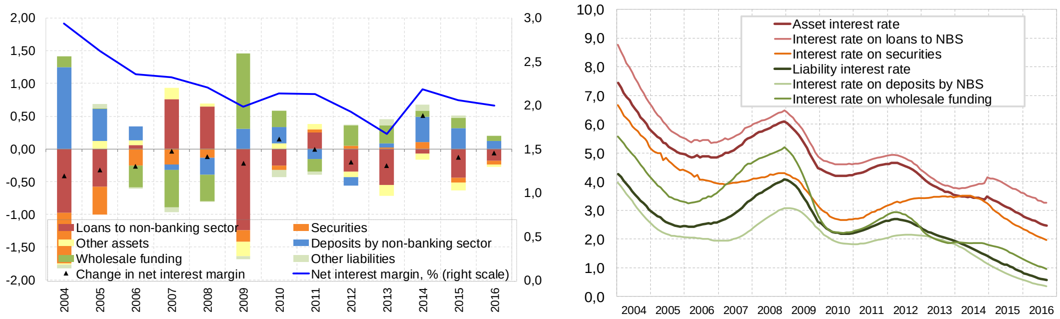
Note 1: Each calculation in the left figure takes account of 12-monthly moving sums of interest income/expenses.
Note 2: In the right figure the change in asset items is the sum of the contributions made by loans, securities and other interest-bearing assets, while the change in liability items is the sum of changes in deposits by the non-banking sector, wholesale funding and other interest-bearing liabilities. The change in the effect of liability items is multiplied by -1, as for example a rise in liability interest rates acts to reduce the net interest margin, while a fall acts to raise the net interest margin.
Source: Bank of Slovenia

The effects on the decline in the net interest margin from effective interest rates on the asset side also prevail over the effects on the liability side in both years.[25] Analysis of the contributions to changes in the net interest margin from the asset and liabilities sides reveals that the very moderate decline in the net interest margin over the last two years is the result of a larger fall in effective asset interest rates than in effective liability interest rates.[26] In the majority of years since the outbreak of the crisis, the changes on the asset side acted to reduce the net interest margin, while by contrast the changes on the liability side mostly acted to raise it. This has been particularly pronounced in recent years, i.e. since 2013, when there was a sharp fall in effective liability interest rates as a result of the fall in interest rates and the simultaneous increase in the proportion of sight deposits at banks. Contrastingly, in certain years, during the rise in the EURIBOR on the international financial markets (e.g. between 2006 and 2008), interest rates made a strong contribution to the decline in the margin, as they did on the asset side in the opposite direction.

[25] For a more precise itemisation of the contributions to the change in the net interest rate margin between 2004 and 2016 in Slovenia, which reflect the most important instruments on the asset and liability sides, and their yields and effective costs and their shares in the breakdown of interest-bearing assets and liabilities, see the article entitled *Net interest margin in a low interest rate environment: evidence for Slovenia* in Bančni Vestnik (November 2016).

[26] Effective interest rates, which are calculated as interest income/expenses per interest-bearing assets/liabilities.

Figure 2.21: Contributions made by individual instruments on asset and liability sides to change in net interest margin (left), and changes in effective interest rates by main instruments of interest-bearing assets and liabilities (right)



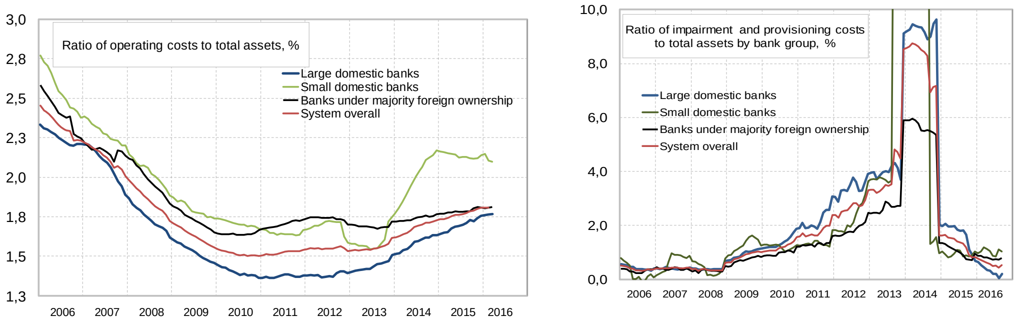
Note 1: The categories are calculated for the preceding 12 months.
Note 2: The left figure illustrates a more precise itemisation of Figure 2.20b by the main instruments.
Source: Bank of Slovenia

In the event of the continuation of the trend of contraction in bank balance sheets, the quantity effect will increasingly act to reduce the banks' net interest margin.[27] As a result of the sharp increase in the proportion of sight deposits and the past fall in interest rates on fixed-term deposits, the banks have less and less room to reduce interest expenses.[28] On the investment side of the balance sheet it is necessary to take additional account of the quarter share accounted for by securities, 57% of which are maturing by mid-2019, and can only be replaced by the banks with lower-yielding securities. The banks generate a fifth of their total interest income through securities. However, certain banks and savings banks, primarily those that have undergone recapitalisation, are notable for a share of securities on the asset side of around a third or even more, and for interest income from securities accounting for a quarter of all interest income. At these banks even greater income pressures on the interest margin and profitability can be anticipated in the coming years.

2) Operating costs, impairment and provisioning costs and profitability

Operating costs declined in 2016. The ratio of operating costs to gross income declined to 57%, as a result of the increase in non-interest income in 2016. The banks reduced operating costs for the sixth consecutive year: the year-on-year decline stood at just under 2% in September. The ratio of operating costs to total assets nevertheless increased slightly, as a result of the faster contraction in the latter.

Figure 2.22: Ratio of operating costs to average total assets (left) and ratio of impairment and provisioning costs to average total assets (right) by bank group



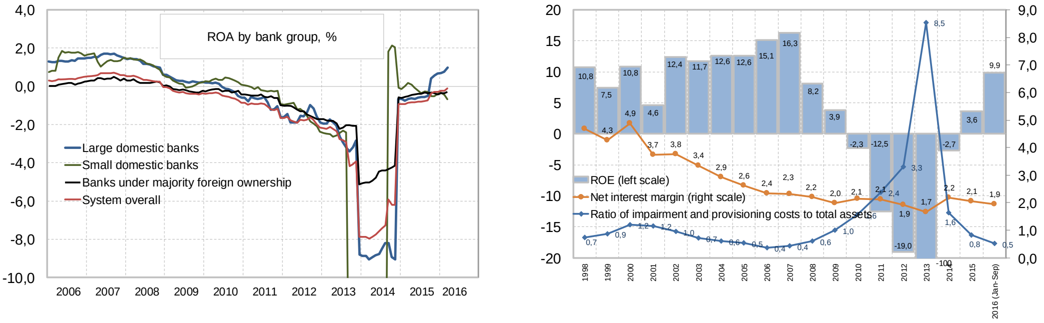
Note: The categories are calculated for the preceding 12 months. Values in excess of 10% of total assets are not depicted in the figure.
Source: Bank of Slovenia

27 As is evident from Figure 2.20a, the decline in net interest income is also attributable to quantity effects. In the wake of the decline in yields on the asset side and the sharp decline in the limit on interest expenses, the banks will have to expand turnover.

28 See for example the footnote on page 75 of the June 2016 Financial Stability Review, which describes what the rough income effect would be in the event of changes in the maturity breakdown of deposits by the non-banking sector that are similar to the previous year, i.e. an increase of 10 percentage points in the proportion of deposits by the non-banking sector accounted for by sight deposits.

Impairment and provisioning costs declined sharply in the first three quarters of 2016, as a result of the improvement in the quality of the credit portfolio. They accounted for less than 5% of the total disposal of gross income over the first nine months of the year. Many banks actually released impairments and provisions over the first eight months of the year, which was attributable to the improved economic situation and the improvement in the quality of the portfolio, which was the result of the resolution of non-performing claims, upgrading of debtors and the repayment of non-performing loans. Impairment and provisioning costs are nevertheless usually above-average in the final quarter of the year, for which reason there can be no expectation of a year-on-year decline as sharp as that in September.

Figure 2.23: ROA by bank group (left), and ROE, net interest margin on interest-bearing assets, and ratio of impairment and provisioning costs to total assets (right), in percentages



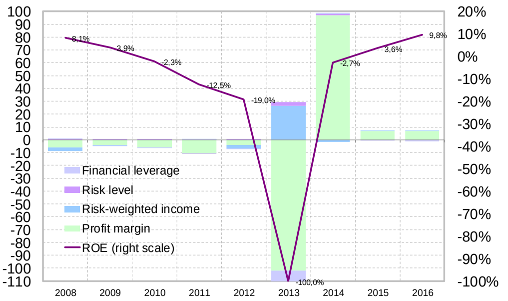
Note: The September 2016 figures for net interest margin on interest-bearing assets and the ratio of impairment and provisioning costs to total assets are calculated over the preceding 12 months. Values of ROA of less than -10% are not depicted in the figure. The September 2016 figure for ROE is calculated for the first nine months of the year (right figure).
Source: Bank of Slovenia

The diminished capacity to generate net interest income could bring another increase in income risk in the banking system in the future. As the favourable effects of the release of impairments and provisions gradually dissipate, and given that the banks cannot significantly increase non-interest income and/or reduce operating costs over the short term, the persistence of the low interest rate environment can be expected to increase income risk. The banks will gradually have to focus more on increasing lending activity, as only in this way can they strengthen the income side of income statement.

Decomposition of profitability

The increase in ROE in 2016 was again attributable to an increase in the profit margin. Analysis of the changes in the banks' ROE via the breakdown of profitability into the four components of profit margin, risk-weighted income, risk level and leverage (see figure below) reveals that profit margin and risk-weighted income contributed to the increase in the banking system's profitability in the first three quarters of 2016. The other two components of risk level and leverage acted to reduce profitability.

Figure 2.24: ROE and impact of four factors on changes in ROE; decomposition of ROE between 2008 and September 2016



Note: 1) The decomposition of ROE is calculated and illustrated for the period to the end of the third quarter of 2016.
Source: Bank of Slovenia

The increase in profitability in 2016 was attributable to the same components as in the previous year. The profit margin, i.e. the ratio of profit to gross income, was strongly positive in

2016 as the banking system generated a profit. This has made a significant contribution to the improvement in profitability for several consecutive years now. Risk-weighted income, the ratio of the banks' gross income to risk-weighted assets, is increasing, as the contraction in loans brought a decline in risk-weighted assets, while the banks' gross income was comparable to the previous year, although the contribution to the improvement in profitability was minimal. Risk level, the ratio of risk-weighted assets to total assets, declined as a result of the deeper contraction in loans than in total assets. Leverage also declined: profits mean that equity in the banking system is increasing, while total assets are declining.

Table 2.4: Individual components in the calculation of ROE by year

	Profit margin		Risk-weighted income		Risk level		Leverage		
	pre-tax profit / gross income	*	gross income / risk-weighted assets	*	isk-weighted assets / total assets	*	total assets / equity	=	ROE
2008	0,22		0,039		0,76		12,08		8,1%
2009	0,11		0,037		0,78		11,93		3,9%
2010	-0,07		0,037		0,78		12,05		-2,3%
2011	-0,37		0,036		0,79		11,79		-12,5%
2012	-0,50		0,043		0,76		11,89		-19,0%
2013	-3,15		0,033		0,74		12,98		-100,0%
2014	-0,09		0,053		0,58		10,06		-2,7%
2015	0,14		0,057		0,53		8,63		3,6%
2016 (1-9)	0,39		0,061		0,51		8,09		9,8%

Note: The top row of the table gives the formula for the calculation of ROE.
Source: Bank of Slovenia

Selected bank performance indicators

Profitability indicators improved in 2015 and the first three quarters of 2016, as a result of the profit generated by the banks. The increase in gross income brought a decline in the ratio of operating costs to gross income, while the net interest margin declined, and the non-interest margin increased on account of factors cited above.

Table 2.5: Selected performance indicators

(%)	2009	2010	2011	2012	2013	2014	2015	Sep 2015	Sep 2016
ROA	0,32	-0,19	-1,06	-1,60	-7,70	-0,27	0,42	0,69	1,21
ROE	3,87	-2,30	-12,54	-19,04	-97,30	-2,69	3,63	6,11	9,89
CIR	53,95	52,22	53,68	47,43	66,04	55,80	59,26	58,47	56,75
Interest margin on interest-bearing assets	1,98	2,14	2,13	1,93	1,68	2,18	2,06	2,08	1,94
Interest margin on total assets	1,88	2,02	2,02	1,83	1,59	2,09	1,96	1,98	1,84
Non-interest margin	1,00	0,86	0,85	1,40	0,85	1,01	1,09	1,03	1,29
Gross income / average assets	2,88	2,88	2,87	3,23	2,44	3,10	3,05	3,01	3,13

Source: Bank of Slovenia

2.4 Interest rate risk

Summary

Interest rate risk remains high, and is one of the more material risks to bank profitability, alongside the persistent relatively high proportion of non-performing claims. In the prevailing low interest rate environment, interest rate risk as measured by the difference between the average repricing periods for asset and liability interest rates and by the interest rate gap illustrates the exposure of the banks' operations to the risk of a rise in interest rates. The lengthening of the average repricing period on investments is exposing the banks to the lengthening of the period of adjustment in interest income at the time of a rise in interest rates. At the same time the average repricing period for funding, which entails interest expenses for banks, is shortening or holding steady, and at just under 5 months is around 13 months shorter than the corresponding period for investments. At the time of a rise in interest rates the banks will be able to more quickly adjust interest rates on the liability side than on the asset side, for which reason the adjustment in interest income will be delayed. Here it should be noted that in a period of rising market interest rates the banks do not hurry to adjust liability interest rates.

The lengthy low interest rate environment is also acting as a brake on bank performance, as it is being accompanied by an increasingly flat yield curve. The interest rate spread on funding and investments is narrowing, which is reducing net interest income. A yield curve of this shape also indicates the expectation of a longer period of low interest rates.

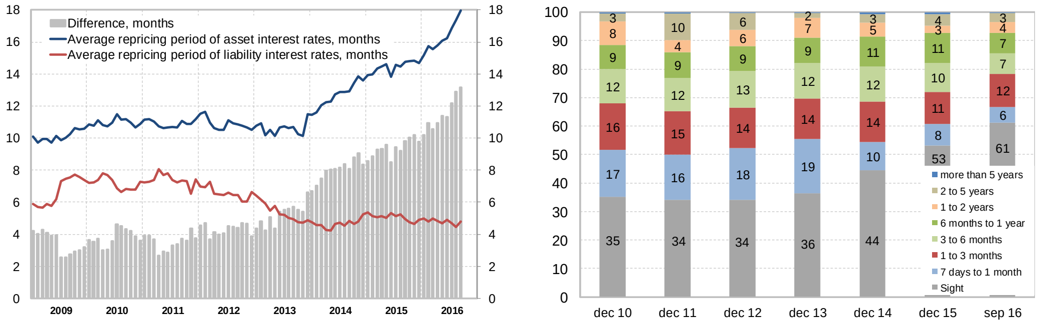
The increase in the proportion of sight deposits is reducing the banks' interest expenses over the short term, but is also introducing instability into the funding structure through the maturity mismatching of assets and liabilities. The banks face the challenge of finding a significant balance between stability and returns. In a longer period of low interest rates, the proportion of sight deposits can be expected to increase slightly further over the next two years.

Interest rate risk is also becoming increasingly material in the international environment, for which reason the Basel Committee issued new standards for interest rate risk in the banking book in April 2016, which are to be implemented by 2018.[29]

Average interest rate repricing period and interest rate gap

The difference between the average repricing periods for asset and liability interest rates reached 13.2 months in September 2016, up 3.4 months in year-on-year terms. The average repricing period for assets lengthened by 3.2 months during this period to 18 months, while the figure for liabilities remained almost unchanged (having shortened by 0.2 months).

Figure 2.25: Average repricing period for the Slovenian banking system's assets and liabilities, in months (left), and breakdown of deposits by average repricing period, in percentages (right)



Source: Bank of Slovenia

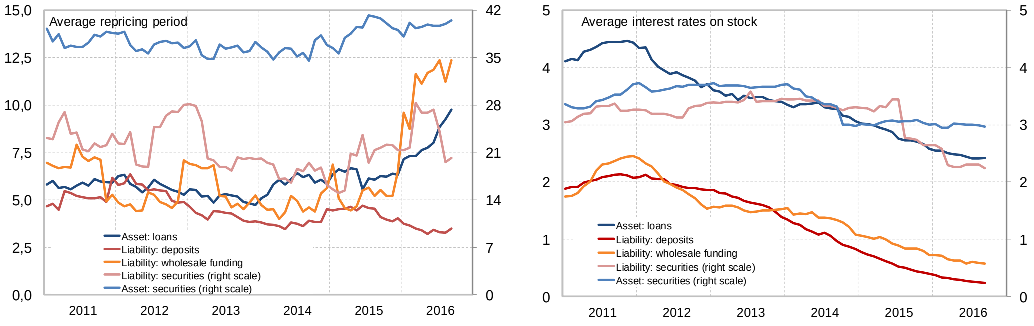
The existing breakdown of deposits by average repricing period suggests that the average repricing period for deposits will shorten very gradually in the future, and given its current level of 3.5 months it will most likely not shorten by much any longer. In the breakdown of deposits by average repricing period, the proportion accounted for by sight deposits began increasing sharply towards the end of 2013. Between September 2015 and September 2016 the proportion accounted for by sight deposits increased by 10 percentage points, while the average repricing period for deposits shortened by 0.6 months over the same period. The relatively small shortening of the average repricing period for deposits, despite the large increase in sight deposits, was primarily the result of a decline in the proportions accounted for by deposits with shorter repricing periods of 7 days to 6 months (which was down 6 percentage points) and 6 months to 1 year (down 3 percentage points), and was less the result of those with longer maturities of more than 1 year, which now merely account for around 7% of the total. The small shortening is also the result of the already relatively short average maturity of deposits.

Simultaneously with the shortening of the average repricing period for deposits, the liability side has also seen the lengthening of the average repricing period for liabilities to foreign banks. The overall average repricing period on the liability side is therefore not shortening significantly. The average repricing period for liabilities to foreign banks lengthened by 6.8 months over the course of one year. The residual maturity of wholesale funding is lengthening, and the proportion of liabilities with a fixed interest rate is increasing. The shift from variable-rate to fixed-rate remuneration on wholesale funding, which is primarily used by banks that are part of international banking groups, is improving the banks' interest rate exposure, but could also entail a

[29] Basel Committee on Banking Supervision, Interest rate risk in the banking book, issued April 2016 (http://www.bis.org/bcbs/publ/d368.htm).

rise in costs. Despite debt repayments, liabilities to foreign banks still account for around 9% of interest-bearing liabilities. In price terms, they are just under 0.5 percentage points more expensive than deposits.

Figure 2.26: Average repricing period for loans, deposits, wholesale funding and securities, in months (left), and interest rates on loans, deposits, wholesale funding and securities, in percentages (right)

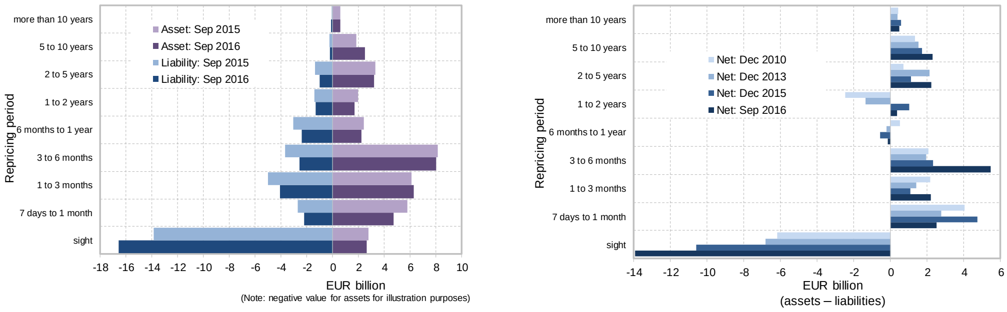


Source: Bank of Slovenia

The average repricing period for assets lengthened by 3.2 months between September 2015 and September 2016, primarily as a result of the lengthening of the average repricing period for loans. The average repricing period for securities on the asset side shortened by 0.3 months, while the average repricing period for loans lengthened by 3.5 months. For all types of loan, the proportion of total loans accounted for by fixed-rate loans, these are loans with an initial rate fixation of more than one year, is increasing. The proportion of the total stock of loans accounted for by fixed-rate loans increased by 3.4 percentage points to just over 12%. The proportion is highest for consumer loans, at almost 32%, followed by corporate loans and housing loans at around 10%. Housing loans are recording the highest growth of all fixed-rate loans.

Slovenian banks are funding assets of various longer maturities through sight deposits. Slovenian banks fund around 30% of interest-bearing assets with a maturity of up to 1 year and around 16% with a maturity of more than 1 year through sight deposits. The two figures were up on the end of 2015, by just over 8 percentage points and 3 percentage points respectively. Net claims with a maturity of 3 to 6 months have increased over the last nine months in particular, as to a lesser extent have those with a maturity of 2 to 10 years. The effective maturity and stability of sight deposits need to be taken into account for the assessment of interest rate risk. Irrespective of the contractual maturity, which for sight deposits is *de facto* zero, sight deposits are classed as funding with indeterminate maturity. Their effective maturity is not unambiguously defined, and under normal market conditions it is the case that it sharply exceeds the contractually determined maturity, and can even amount to several years. In certain interest rate scenarios their effective maturity could be significantly shorter, and could more closely approach the contractual maturity. In the current low interest rate environment deposits could be a haven from the less predictable macroeconomic environment, which is also bringing increased volatility on the capital markets and real estate market. When interest rate begin rising again, these funds will migrate to higher-yield investments, at least to a certain extent, either inside or outside the same bank, which could expose the banks to higher funding costs.

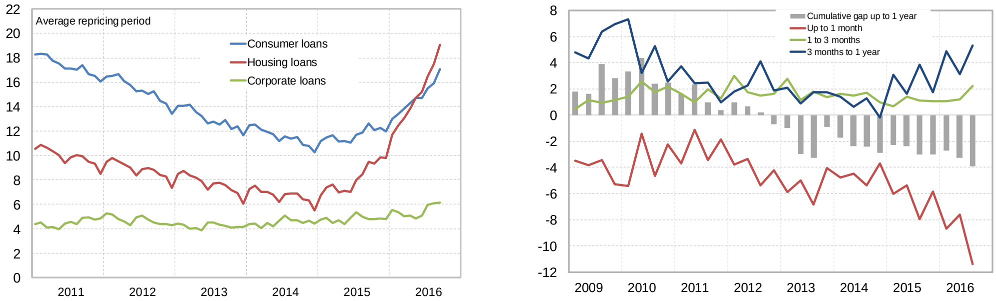
Figure 2.27: Assets and liabilities of the Slovenian banking system by average repricing period in September 2015 and September 2016 (left), and gap (assets minus liabilities) by average repricing period at the end of 2010, 2013 and 2015 and in September 2016 (right), in EUR billion



Source: Bank of Slovenia

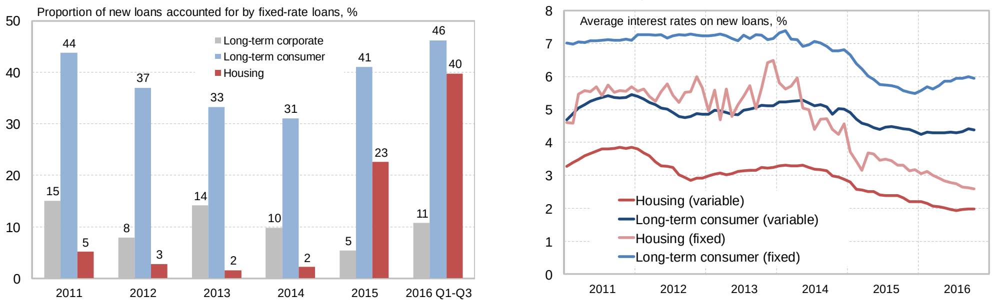
The small domestic banks and large domestic banks are more exposed to interest rate risk, while the banks under majority foreign ownership are less exposed. Exposure to interest rate risk varies greatly from bank to bank. The banks have several options for managing interest rate risk with regard to the individual strategy adopted. The banks close their exposure to interest rate risk by means of active management of the securities portfolio. Certain banks, larger banks in particular, also close their exposure to interest rate risk by means of derivatives. The banks that are part of international banking groups enter into derivative contracts with their parent banks. In managing the maturity breakdown of assets and liabilities, the banks are also attentive to the price of individual instruments. Interest rates on sight deposits are close to zero, which given the longer average maturity on the asset side is allowing them to continue generating a certain net interest income despite the contraction in total assets and the low interest rate environment.

Figure 2.28: Average repricing period for individual types of loan, in months (left), and gap between interest-bearing assets and liabilities in maturity buckets up to 1 year, in EUR billion (right)



Source: Bank of Slovenia

Figure 2.29: Proportion of loans with a fixed interest rate (left), and average interest rates (right) for individual types of new loans, in percentages



Source: Bank of Slovenia

2.5 Refinancing risk and bank liquidity

Summary

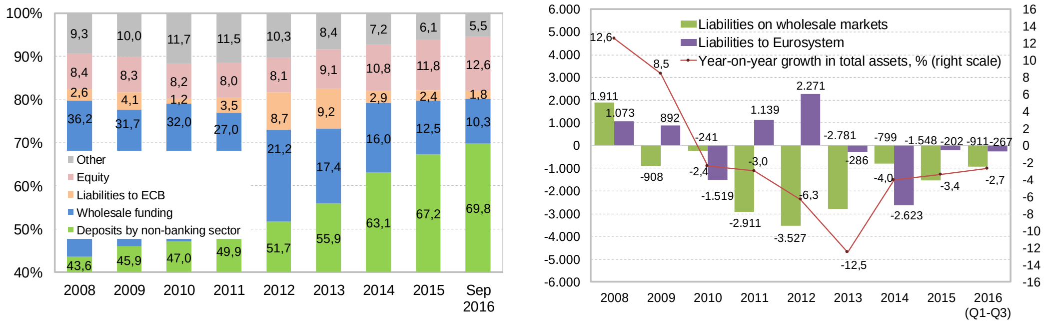
Refinancing risk in the Slovenian banking system remains low, although the shortening of funding maturities is increasing the risk to its stability. The funding structure is continuing to shift towards deposits by the non-banking sector, household deposits in particular. The extremely low level of deposit rates means that the proportion of deposits by the non-banking sector accounted for by sight deposits is increasing further, which is increasing the possibility of a rapid withdrawal of funds from banks in the event of any unforeseen extreme shocks. Adequate secondary liquidity thus remains important, to help the banks bridge any liquidity pressures. This is particularly the case in the new circumstances, when the banks are focusing more attention on reducing funding than on attracting new credit operations. Given their high excess liquidity, Slovenian banks also have at their disposal a high percentage of the pool of eligible collateral for Eurosystem operations that is free, and thus the opportunity to obtain additional liquid assets. The continuation of low interest rates and high excess liquidity throughout the euro area will continue hampering Slovenian banks in their effective management of excess liquidity in the shallow money market.

2.5.1 Continuing changes in funding structure

The leading role in funding played by deposits by the non-banking sector is continuing to strengthen. The proportion of total funding accounted for by deposits by the non-banking sector had increased to 70% by the end of September 2016. In addition to the increase in their stock, last year's rise in the proportion accounted for by deposits by the non-banking sector was attributable to the banks' ongoing debt repayments on wholesale markets and the decline in liabilities to the Eurosystem.

By the end of September the proportion accounted for by wholesale funding was down just under a third on its level before the outbreak of the financial crisis. The banks are continuing to repay liabilities to foreign banks, and as issued debt securities mature they have no need to roll over the issues. Issued debt securities are a more expensive form of funding, and are thus less attractive to banks from the perspective of cost.

Figure 2.30: Percentage breakdown of bank funding (left), and changes in liabilities to the Eurosystem and wholesale funding, in EUR million (right)

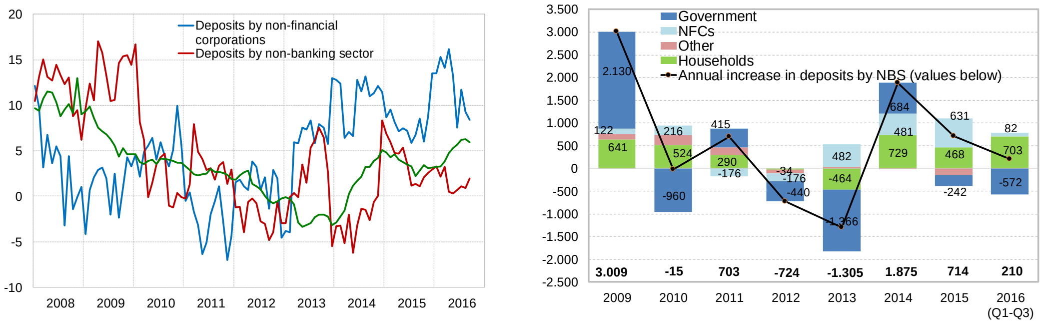


Note: Wholesale funding comprises liabilities to banks in the rest of the world and issued debt securities.
Source: Bank of Slovenia

Growth in deposits by the non-banking sector is the result of growth in household deposits and deposits by non-financial corporations. Year-on-year growth in deposits by the non-banking sector reached 1.9% in September 2016. The positive impact on deposits by the non-banking sector of increases in household deposits and deposits by non-financial corporations was slightly neutralised by withdrawals of government deposits in the amount of EUR 0.6 billion. As loans to the non-banking sector decline and deposits by the non-banking sector grow, the indicator of the sustainability of funding, the LTD ratio, is declining, and reached 77.3% by September 2016. The low value of the indicator reveals the moderate direction of primary funding, i.e. deposits by the non-banking sector, into basic banking activity, i.e. loans to the non-banking sector.

Growth in deposits by non-financial corporations, which account for 15% of total funding, has slowed, but still stood at a solid 8.4% in year-on-year terms at the end of September 2016. Growth in these deposits is not expected to strengthen in the future: the banks have begun to charge fees for corporate sight deposits, which account for the majority of deposits. In addition, the extremely low level of interest rates means that there is no incentive for firms to commit the funds that they have in bank accounts for a fixed term.

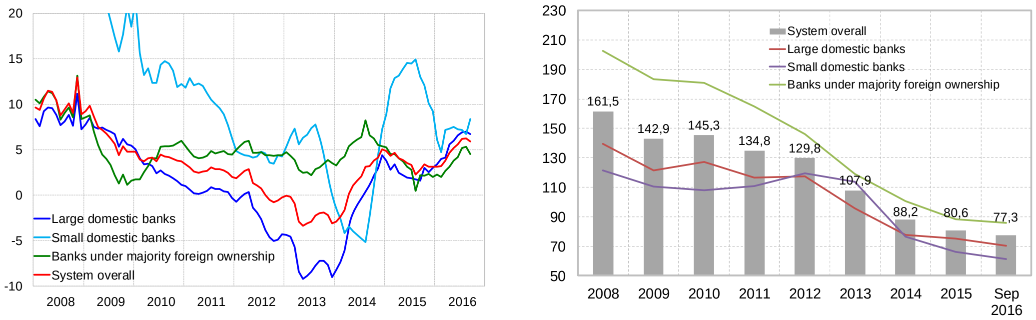
Figure 2.31: Growth in deposits (left), and increase in deposits, in EUR million (right) by institutional sector



Source: Bank of Slovenia

Household deposits have continued to increase in importance, and accounted for 45% of bank funding at the end of September 2016. Despite extremely low interest rates, the stock of the aforementioned deposits increased by EUR 703 million over the first nine months of the year, to reach EUR 16.3 billion. Year-on-year growth in household deposits strengthened during the year, reaching 5.9% in September. Strengthening growth was seen at all the bank groups, although the competing via interest rates typical of previous years was not seen. All the banks adjusted to the low interest rate environment, and reduced deposit rates to a minimal level. Short-term and long-term interest rates on deposits at Slovenian banks remain below the euro area average.

Figure 2.32: Growth in household deposits (left) and LTD ratio (right) by bank group, in percentages

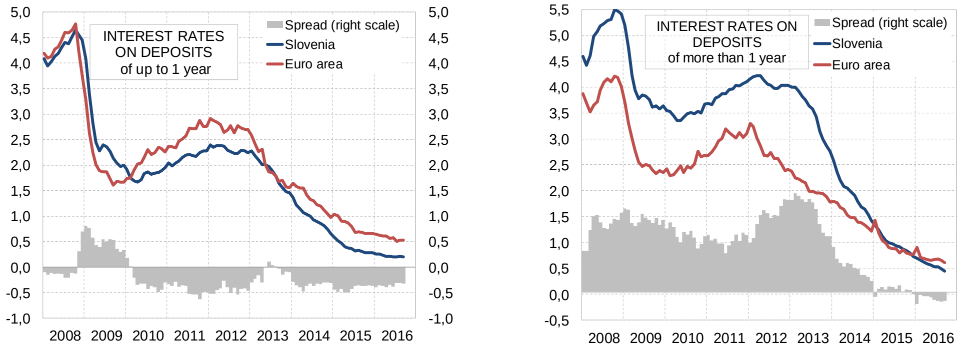


Source: Bank of Slovenia

Shortening of deposit maturities: potential instability in bank funding

The maturity breakdown of deposits by the non-banking sector has continued to shift in the direction of an increase in sight deposits. The proportion of total deposits by the non-banking sector accounted for by sight deposits increased by just under 7 percentage points over the first nine months of the year to reach 62%, as the proportions accounted for by short-term and long-term fixed deposits declined. The fall in interest rates on fixed-term deposits increased the proportion of sight deposits at all the bank groups. This is particularly evident at the small domestic banks and savings banks, which in 2015 had succeeded in competing via slightly higher deposit rates, but have now adjusted to the given situation, largely as a result of income pressure. The average interest rate on fixed-term deposits of up to 1 year declined to 0.2% over the first nine months of the year, compared with 0.5% for deposits of more than 1 year. Both figures are below the euro area average.

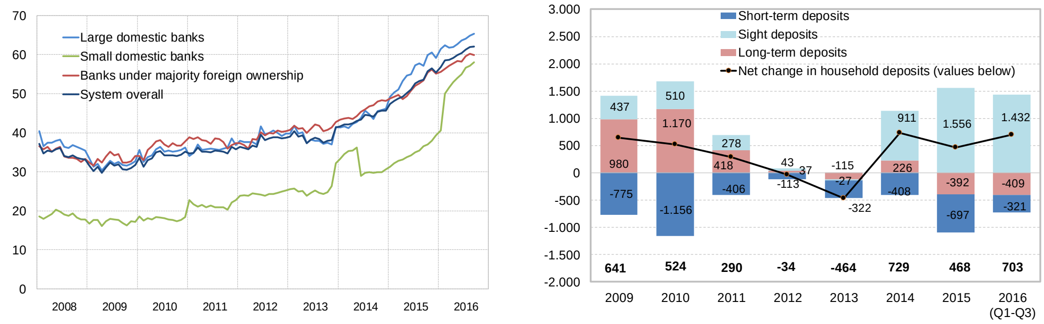
Figure 2.33: Comparison of interest rates in Slovenia with interest rates across the euro area for new household deposits, in percentages



Source: Bank of Slovenia

Low interest rates have shortened the maturity breakdown of deposits in the majority of EU Member States. The average proportion of total liabilities accounted for by deposits by the non-banking sector on a consolidated basis across EU Member States increased by 1 percentage point in 2015, to just over 20%. In Slovenia the proportion increased by 8 percentage points to 37%, one of the highest figures in the EU.

Figure 2.34: Percentage of deposits by the non-banking sector accounted for by sight deposits by bank group, in percentages (left), and breakdown of changes in the stock of household deposits by maturity (right)

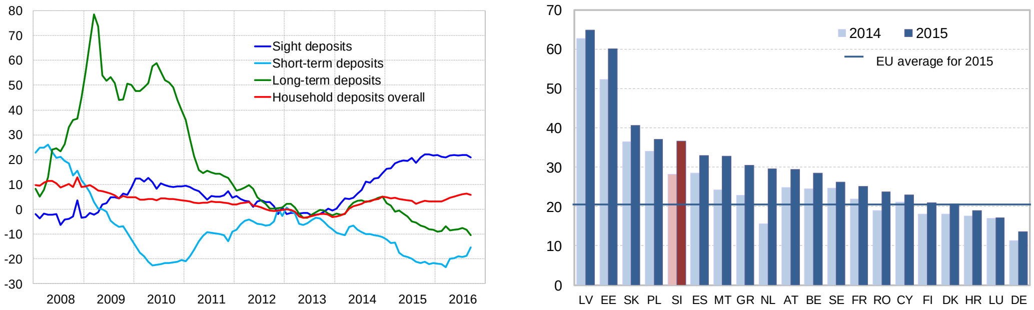


Source: Bank of Slovenia

The main factor in the shortening of the average maturity of deposits by the non-banking sector is the increase in sight deposits within the most important source of funding, i.e. household deposits. The stock of sight deposits by households increased by EUR 1.4 billion over the first nine months of the year, half of which came from maturing short-term and long-term fixed deposits, which are mostly not being rolled over. The fall in interest rates on fixed-term deposits to minimal levels is deterring savers from recommitting their funds in fixed-term forms, for which reason they are building up in current accounts at banks. For this reason the new inflows into the banks from households are of a sight nature. Year-on-year growth in sight deposits by households stabilised over the first nine months of the year at a high 21%, while short-term and long-term deposits by households have simultaneously continued to decline.

The increase in the proportion of sight deposits is having an negative impact on the stability of bank funding structure, as it is increasing the possibility of a rapid withdrawal of savers' funds from banks in the event of potentially extreme shocks, which could create liquidity pressure on the banks. Given the lack of higher-yielding alternative investments, the non-functioning capital market, and the assumption that savers in Slovenia continue to favour traditional forms of saving, the likelihood of a mass withdrawal of sight deposits is low over the short term.

Figure 2.35: Growth in household deposits by maturity (left), and average proportion of total liabilities accounted for by sight deposits by the non-banking sector on a consolidated basis across EU Member States (right), in percentages



Sources: Bank of Slovenia, ECB (SDW)

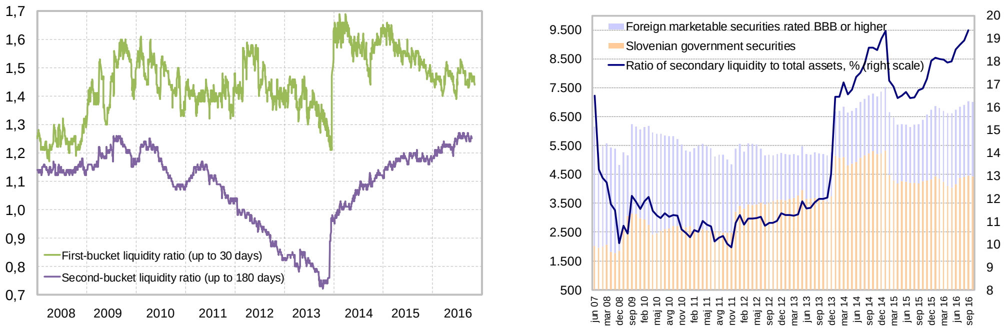
2.5.2 Liquidity risk

The Slovenian banking system's liquidity risk remained low and stable in 2016. The first liquidity indicator to support this assertion is the relatively high first-bucket liquidity ratio. It fluctuated slightly over the first nine months of the year, but averaged 1.47 in October, comparable to the end of the previous year. The second-bucket liquidity ratio also stabilised in the second half of the year, averaging 1.25 in October, above its level from before the outbreak of the financial crisis.

Further evidence of the good liquidity position came from the increase in the proportion of total assets accounted for by secondary liquidity, which reached 19.4% at the end of September. The increase was the result of both an increase in the stock of marketable secondary liquidity, and the continuing decline in total assets. The stock of marketable secondary liquidity increased by EUR 235 million over the first nine months of the year to EUR 7 billion. In light of the increase in sight deposits, and the consequent increased chance of their rapid withdrawal, an adequate stock of secondary liquidity will make a significant contribution to bridging any liquidity pressure placed on the banks.

The concentration of Slovenian government securities in marketable secondary liquidity is slowly diminishing, but remains relatively high. The proportion accounted for by Slovenian government securities declined by just under 1 percentage point over the first nine months of the year to 63%. Exposure to concentration risk is highest at the small domestic banks, whose secondary liquidity consists exclusively of Slovenian government securities. They accounted for 27% of total assets at the small domestic banks in September 2016. However, the improvement in the economic and financial situation in Slovenia has had a favourable impact on sovereign credit ratings, which is reducing the chances of the actual realisation of concentration risk.

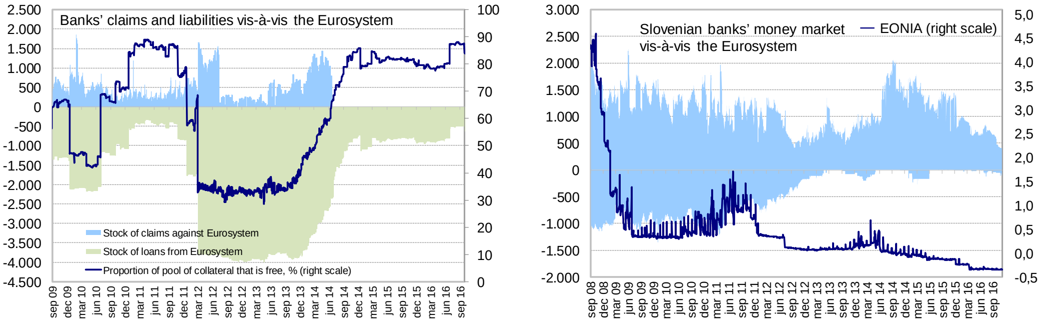
Figure 2.36: Daily first-bucket and second-bucket liquidity ratios (left), and stock of marketable secondary liquidity, monthly averages (right)



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

The high proportion of the pool of eligible collateral at the Eurosystem that is free provides further evidence of the favourable liquidity position of Slovenian banks. This proportion improved significantly after the repayment of the TLTRO in early July, and had stabilised around 87% by the end of September. In the context of high excess liquidity, which amounted to EUR 2.5 billion at the end of September 2016, the banks have as expected shown little interest in obtaining additional funding from the Eurosystem. They reduced this funding to EUR 635 million by September, accounting for 1.8% of the Slovenian banking system's total funding.

Figure 2.37: Banks' claims and liabilities vis-à-vis the Eurosystem, in EUR million, and proportion of the pool of eligible collateral that is free (left), and stock of unsecured loans of Slovenian banks placed and received on the euro area money market (right)



Source: Bank of Slovenia

The low interest rate environment and high excess liquidity throughout the euro area will continue hampering the effective management of excess liquidity in the euro area money market. Slovenian banks remain net creditors in the aforementioned market: their net claims declined by EUR 578 million over the first nine months of 2016 to stand at EUR 413 million. The banks under majority foreign ownership are less active, most likely as a result of the continuing deepening of negative interest rates. Given the persistence of the low interest rate environment and high excess liquidity throughout the euro area, there is no expectation of a significant change in the situation in the management of excess liquidity in the euro area money market.

2.6 Bank solvency

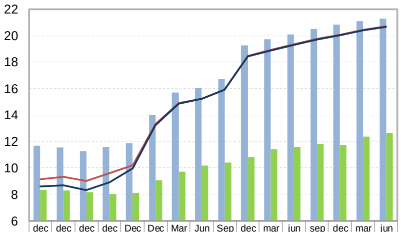
Summary

The Slovenian banking system's solvency risk remains low, although there remain significant differences in the capital positions of different banks. The banking system's capital adequacy on an individual basis improved, as a result of profits and increased reserves, which increased capital. At the same time the optimisation of operations and the improvement in the quality of the credit portfolio brought a further decline in capital requirements. There was an additional improvement in the high quality of the capital structure, as the stock of subordinated instruments declined. The large domestic banks are notable for their good capital position, while the small domestic banks remain the most vulnerable bank group in capital terms. The maintenance of the capital position in the future will largely be dependent on the ability to generate internal capital, which is limited in the context of persistently weak lending activity and the low interest rate environment. At the same time the further optimisation of the use of capital will be important, and will depend primarily on the further clean-up of bank balance sheets and a change in the banks' investment structure.

Capital adequacy

The Slovenian banking system's capital adequacy is continuing to increase moderately. The total capital ratio increased by 0.5 percentage points in the first half of 2016 to stand at 21.3%. The Tier 1 capital ratio and the common equity Tier 1 capital ratio also increased over the same period, each by 0.6 percentage points to 20.7%. The already small gaps between the capital ratios narrowed further in the first half of the year, as certain banks reduced their stock of subordinated instruments.

Figure 2.38: Banking system's basic capital ratios on an individual basis, in percentages



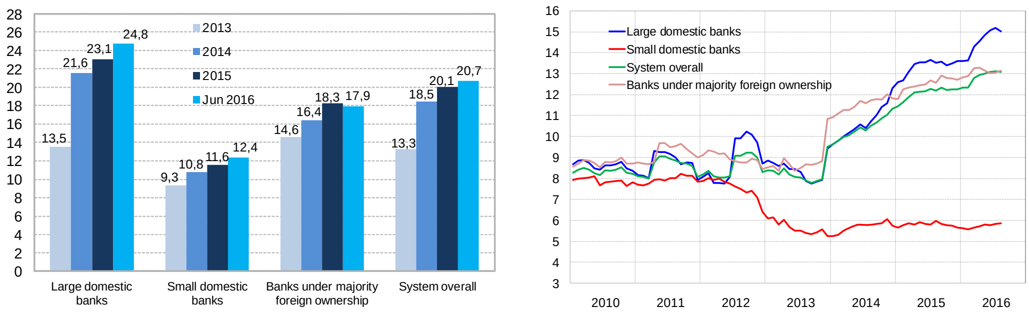
	dec 08	dec 09	dec 10	dec 11	Dec 12	Dec 13	Mar 14	Jun 14	Sep 14	dec 14	mar 15	jun 15	sep 15	dec 15	mar 16	jun 16
TCR	11,7	11,6	11,3	11,6	11,9	14,0	15,7	16,0	16,7	19,28	19,7	20,1	20,5	20,84	21,1	21,3
Capital / total assets	8,4	8,3	8,2	8,0	8,1	9,1	9,7	10,2	10,4	10,83	11,4	11,6	11,8	11,8	12,4	12,6
T1CR	9,2	9,3	9,0	9,6	10,2	13,3	14,9	15,2	15,9	18,47	18,9	19,3	19,8	20,1	20,4	20,7
CET1CR	8,6	8,7	8,3	8,9	10,0	13,2	14,9	15,2	15,9	18,44	18,9	19,3	19,7	20,0	20,4	20,7

Source: Bank of Slovenia

There remain significant differences in capital adequacy between the bank groups.[30] The large domestic banks are notable for the highest total capital ratio, which increased by 1.7 percentage points in the first half of 2016 to stand at 24.8%. It was primarily attributable to their profitability during this period, which allowed them to increase capital, while the ongoing contraction in turnover reduced their capital requirements. After several years of continual increase, the total capital ratio at the banks under majority foreign ownership declined in the first half of 2016, by 0.8 percentage points to 18.9%. With capital requirements remaining unchanged, the bank group recorded a decline of EUR 73 million in regulatory capital, where the majority of the decline was the result of a decline in subordinated instruments.

The small domestic banks and savings banks remain the most vulnerable bank group in capital terms, despite an improvement in capital adequacy. Their total capital ratio increased by 0.7 percentage points in the first half of the year to stand at 13.7%, still significantly below the average across the Slovenian banking system. Regulatory capital in this bank group increased as a result of recapitalisation and profits, which brought an improvement in capital adequacy as their capital requirements simultaneously declined. The small domestic banks are more exposed to solvency risk than the other bank groups, owing to their small ratio of capital to total assets, which remains below 6%.

Figure 2.39: Tier 1 capital ratio (left), and ratio of book capital to total assets (right), on an individual basis by bank group, in percentages



Source: Bank of Slovenia

Capital and capital requirements

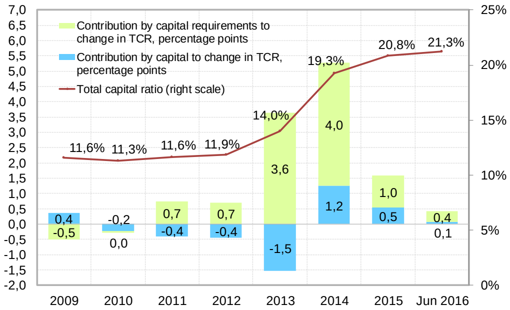
As in previous years, the improvement in the banking system's capital adequacy in the first half of 2016 was primarily attributable to a decline in capital requirements, and less to an increase in regulatory capital, whereby the size of the changes was less than in the past. Regulatory capital increased by a modest EUR 11 million over the first six months of the year to EUR 4,090 million, as the increase of EUR 53 million in Tier 1 capital was partly neutralised by a decline in subordinated instruments at certain banks. The increase in Tier 1 capital was primarily attributable to profits and an increase in reserves, and less to recapitalisations, which were successfully carried out at just two banks during this period. The high quality of the banking

[30] Poštna banka Slovenije d.d. is included under the small domestic banks and savings banks in this section, as the data is for the period to June 2016, when it was still operating independently and had not yet been absorbed into Nova Kreditna banka Maribor d.d.

system's capital structure was further improved by a reduction of 1.1 percentage points in the proportion of Tier 2 capital to just 2.6%.

The ability to generate internal capital will make a significant contribution to the maintenance of a stable capital position in the future. The generation of profit remains limited in the environment of low interest rates and low lending activity. The increase in the banking system's profit in the first half of 2016 was the result of a year-on-year decline in impairment and provisioning costs, and not growth in net interest income. Because this way of generating internal capital is not sustainable over the long term, the banks will have to continue seeking new opportunities to adjust their business to the given economic situation.

Figure 2.40: Contribution to change in total capital ratio on an individual basis made by changes in capital and capital requirements, in percentage points

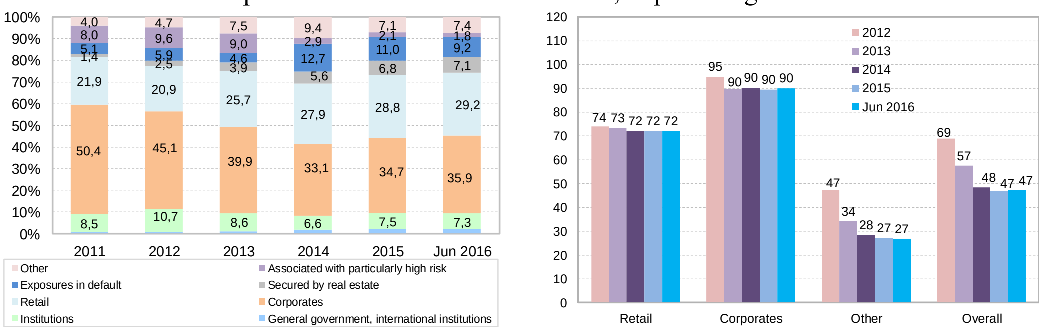


Source: Bank of Slovenia

The decline in capital requirements was slower than in previous years. The decline in the first half of the year was attributable to an improvement in the quality of the credit portfolio, and optimisation of operations. Capital requirements declined by EUR 27 million over the first half of the year to EUR 1,539 million, half of which was the result of a decline in capital requirements for operational risk. The banks are reducing their operational risk though greater efficiency in operations, and are thereby gradually removing the burden on capital. The proportion of total capital requirements accounted for by capital requirements for operational risk fell below 10% in the first half of the year.

The improvement in the quality of Slovenian banks' credit portfolio was evident in lower capital requirements for exposures associated with particularly high risk and exposures in default. They declined by just over 16% in the first half of the year. At the same time the optimisation of the use of capital was evidenced in further growth in capital requirements for exposures secured by real estate collateral, which allow banks to apply lower risk weights. The ongoing clean-up of bank balance sheets, greater operational efficiency, and a focus on safer investments such as household loans and securities could in the future make a significant contribution to optimising the use of capital, and thus to maintaining a stable capital position.

Figure 2.41: Breakdown of capital requirements for credit risk (left), and risk weights (right), by credit exposure class on an individual basis, in percentages



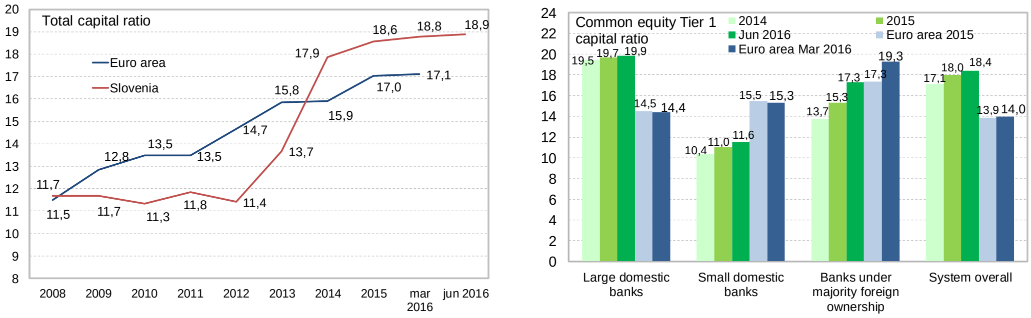
Note: The risk weight is calculated as the ratio of risk-weighted assets for credit risk to the total credit exposure for each class of credit exposure, expressed as a percentage.
Source: Bank of Slovenia

Comparison of capital adequacy with the euro area (consolidated figures)

The Slovenian banking system's capital adequacy on a consolidated basis has continued to increase moderately. The total capital ratio increased by 0.3 percentage points in the first half of 2016 to stand at 18.9%, and thus remained above the average across the euro area. The same applies to the Tier 1 capital ratio and the common equity Tier 1 capital ratio, each of which increased by 0.4 percentage points in the aforementioned period to 18.4%.

In contrast to the increase in capital adequacy on an individual basis, the increase in capital adequacy on a consolidated basis is solely the result of a decline in capital requirements. In addition to capital requirements there was a decline in capital, as the positive effects of profit and increased reserves were insufficient to outweigh the decline in Tier 2 capital that occurred as a result of the repayment of subordinated instruments at certain banks.

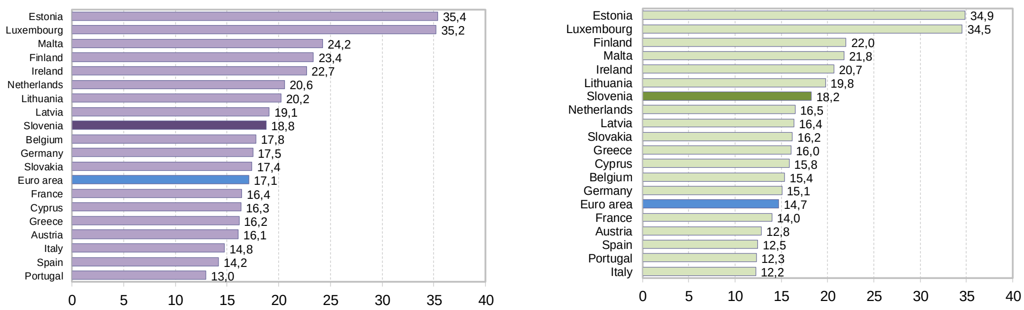
Figure 2.42: Total capital ratio for the banking system (left), and common equity Tier 1 capital ratio by bank group (right), compared with the EU, on a consolidated basis, in percentages



Note: For the sake of comparability, medium-size euro area banks are included under large domestic banks.
Sources: Bank of Slovenia, ECB (SDW)

In contrast to the euro area overall, Slovenian banks are meeting their capital adequacy requirements through the highest-quality forms of capital. This is reflected in the minimal difference between the total capital ratio and the Tier 1 capital ratio at Slovenian banks, compared with the significant difference between the two ratios in the euro area overall. In addition, the higher-quality structure of the Slovenian banking system's capital is also evidenced in the higher ratio of Tier 1 capital to total capital. This stood at just over 97% in June 2016, 11 percentage points more than the most recent figure available for the average across the euro area. Future growth in regulatory capital will mostly depend on an increase in Tier 1 capital, as the likelihood of Slovenian banks being able to increase their regulatory capital through subordinated debt is relatively low.

Figure 2.43: Total capital ratio (left) and Tier 1 capital ratio (right) by euro area country in March 2016, in percentages

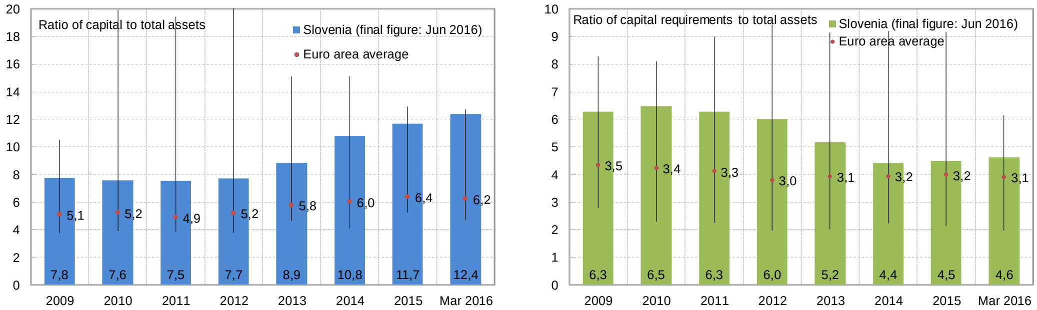


Sources: Bank of Slovenia, ECB (SDW)

The favourable capital position of Slovenian banks is evidenced in the increasing ratio of book capital to total assets. It stood at just over 12% in June 2016, double the average across the euro area. However, the ratio is not increasing solely as a result of the generation of profits, and thus an increase in book capital, but also as a result of the continuing contraction in total assets.

The ratio of capital requirements to total assets reveals a less favourable position on the part of Slovenian banks compared with the euro area overall. This solvency indicator stood at 4.6% at the end of June 2016, compared with an average across the euro area of 3.1%. The pace of the contraction in Slovenian banks' capital requirements has slowed in recent years, and is lower than the pace of the contraction in total assets, for which reason the indicator is increasing gently. That the ratio of capital requirements to total assets is higher than in the euro area overall continues to be attributable to the use of the standardised approach at the majority of Slovenian banks, and the actual structure of the capital requirements, which are limiting the application of lower risk weights. Should investment structure subsequently shift towards an increase in securities and household loans, the resulting change in the structure of capital requirements will allow the banks to improve the use of capital. The continuing clean-up of bank balance sheets will also contribute to reducing the burden on capital.

Figure 2.44: Distribution of the ratio of book capital to total assets (left), and ratio of capital requirements to total assets (right), for euro area countries, figures on a consolidated basis, in percentages



Sources: Bank of Slovenia, ECB (SDW)

Box 4: Minimum requirements for own funds and eligible liabilities (MREL)

The purpose of this box is to present the minimum requirements with regard to own funds and eligible liabilities, and on the basis of the EBA's findings and recommendations[31] to assess the potential effects for Slovenian banks.

The minimum requirements for own funds and eligible liabilities (hereinafter: MREL) are defined by the BRRD.[32] Eligible instruments are defined in Article 45 of the BRRD, and include own funds, subordinated debt and senior unsecured debt with at least 12 months remaining on their terms that can be used in a bail-in. The national resolution authority may set out additional criteria for determining the MREL requirements.

Difficulties in meeting the MREL requirements, particularly when subject to binding subordination, could be seen at banks that primarily fund themselves through deposits and that only have limited access to the financial markets. This could be exacerbated if the country where they operate has a poorly developed capital market. The market in subordinated instruments in many countries is limited in terms of size and liquidity. For Slovenian banks, meeting the MREL requirements in the event of binding subordination is even more problematic, given the historical experience of bail-in. It can therefore be anticipated that the banks will largely meet the MREL requirements through own funds and unsecured debt, which could be reflected in higher funding costs.

The significance of the MREL requirements is in the clear definition of the subordination of individual liabilities in the event of resolution according to the principle that no creditor may be worse off than in the event of bankruptcy. At the same time meeting the MREL requirements provides funding for bank resolution in a manner such that the majority of the costs of resolution are borne by the owners and unsecured creditors, thereby reducing the risk of moral hazard and the risk of bank resolution via public bail-out. The benefits of meeting the MREL requirements lie in

[31] EBA: Interim Report on MREL. Report on implementation and design of the MREL Framework. EBA-Op-2016-12, 19 July 2016, https://www.eba.europa.eu/documents/10180/1360107/EBA+Interim+report+on+MREL.

[32] Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms, 15 May 2014, http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0059.

the reduction of the probability of a crisis and the mitigation of the potential effects of a crisis, which reduces the risks to financial stability and to depositors.

In stress situations there will still be the option of intervening with public funds at the level of the system as a whole, but only when owners and unsecured creditors have covered losses in the amount of 8% of the banks' total assets or 20% of risk-weighted assets under additional conditions, whereby resolution via the assets of the resolution fund will be limited to 5% of a bank's total assets.

The MREL will be defined for each bank with regard to the resolution plan and projected amount, and with regard to its systemic importance. For banks where ordinary insolvency proceedings could endanger the financial stability of the entire system, the requirements with regard to the amount of MREL-eligible instruments will be set at a level that allows for loss absorption and recapitalisation in an amount that allows the regulatory requirements to be met and the restoration of the markets' confidence in the institution that is the subject of resolution. The requirement will be appropriately smaller at banks whose wind-up does not endanger financial stability. The MREL requirements have not yet been defined for individual banks. The globally systemically important banks will first be informed of their notional requirements, and the expectation is that they will be followed by other systemically important banks, and then finally all other banks for whom the national resolution authority will set requirements.

The European Commission issued an update to the BRRD[33] in late November 2016, which ties the MREL requirements to risk-weighted assets or leverage ratio exposure. It additionally defines the MREL in the direction of greater compliance with the TLAC.[34]

The requirements with regard to subordination of financial instruments are also a material aspect. Subordinated instruments constitute a buffer between capital and deposits. The amount of unsecured debt of other creditors that is also included in MREL may be converted into secured debt that is not subject to bail-in, as a result of better awareness of the collateral requirements in the period before the beginning of the resolution of the bank. In accordance with the TLAC requirements, by 2022 globally systemically important institutions are expected to meet the MREL requirements in the amount of 14.5% of risk-weighted assets through subordinated instruments, while other systemically important institutions are expected to meet the requirements in the amount of 13.5% of risk-weighted assets. Here the national authorities have the option of introducing the requirements in connection with subordination gradually, with regard to the banks' access to the market and the market's capacity to absorb such instruments, over a longer time horizon and differently for each bank.

The assessment of the effects of the introduction of MREL on Slovenian banks is made on the basis of available data, which is limited in terms of scope and provides only a rough assessment. Analysis is conducted on data submitted by the banks within the framework of the Single Resolution Board enquiry (LDT forms), where the scope of reporting is limited, and includes certain instruments with clauses that could entail their non-eligibility for meeting the MREL requirements. There are therefore two options with regard to the available scope of eligible instruments:

The narrowly defined scope of MREL-eligible instruments, in which subordinated and senior unsecured debt with at least 12 months remaining on their terms are taken into account alongside own funds.

The broader definition of MREL, in which, in addition to own funds, all debt instruments with a residual maturity of at least 12 months eligible for bail-in,[35] which also includes deposits not covered by a guarantee scheme, are taken into account.

With regard to the required level of MREL, calibration is undertaken on the basis of the EBA report,[36] which divides the requirements with regard to the MREL ratio into two parts:

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[33] Proposal for a directive amending Directive 2014/59/EU on loss-absorbing and recapitalisation capacity of credit institutions (http://ec.europa.eu/transparency/regdoc/rep/1/2016/EN/COM-2016-852-F1-EN-MAIN.PDF).

[34] TLAC (total loss-absorbing capacity) consists of the comparable requirements defined for globally systemically important institutions by the FSB.

[35] Includes all funding that pursuant to Article 44 of the BRRD is not excluded from the scope of the bail-in tool.

[36] EBA: Interim Report on MREL. Report on implementation and design of the MREL Framework. EBA-Op-2016-12, 19 July 2016, https://www.eba.europa.eu/documents/10180/1360107/EBA+Interim+report+on+MREL.

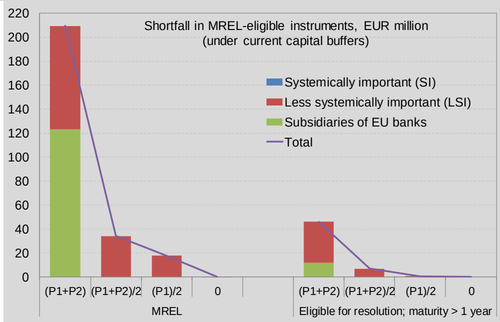
1) for loss absorption,

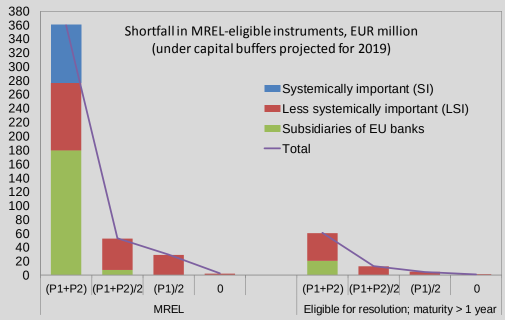
2) for recapitalisation.

The first part relates to the required capital adequacy, which includes Pillar 1 requirements (P1), the Pillar 2 requirements on the basis of the SREP (P2), and the combined capital buffer requirement (CBR). There are several unclear issues with regard to the recapitalisation requirement. It is highly unlikely that it would be defined in the amount of the total required capital adequacy, primarily because the purpose of the capital buffers is for them to be built up during favourable times when risks accumulate, and to be released in more adverse times. A recapitalisation requirement defined without buffers (P1 + P2) could be the most demanding. The second hesitation relates to the consideration of the results of stress tests in the required recapitalisation of a bank in the resolution phase, for which reason there is no need to take full account of the Pillar 2 requirement. In the event of resolution via a bridge bank, which would retain only the critical functions, while part of the portfolio would be transferred to another institution, the recapitalisation requirement would be correspondingly smaller. Scenarios in which the MREL recapitalisation requirement is defined in the amount of 50% of (P1 + P2) and 50% of P1 are therefore illustrated below. For a bank whose resolution plan envisages wind-up, there is no need for any MREL recapitalisation requirement.

Here it should be noted that until the full implementation of the MREL requirements, the capital buffer requirements will also be tightened. There is no expectation of the required rate for the countercyclical capital buffer turning positive by 2019, while the capital conservation buffer in the amount of 2.5% and the O-SII buffer, currently 1% for NLB and 0.25% for the other systemically important banks included, will be in full effect, which slightly worsens the estimated shortfall.

Figure 2.45: Estimated shortfall in MREL-eligible instruments, under various options for defining the recapitalisation requirement with regard to current capital buffers (left) and with regard to the projected capital buffer requirements in 2019 (right), in EUR million



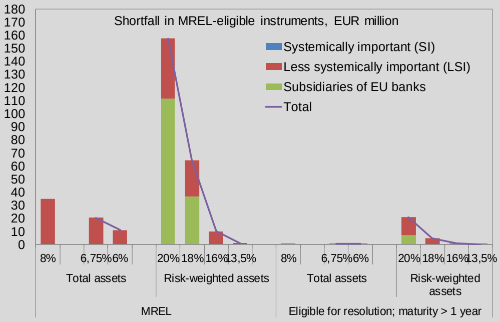


Note: In all assessments the assumption is that the MREL requirement consists of a loss absorption requirement and a recapitalisation requirement. The loss absorption requirement is defined by the capital requirement for the individual bank in 2016, including the Pillar 1 requirements (P1), the Pillar 2 requirements on the basis of the SREP (P2), and the combined capital buffer requirement (CBR). The left figure takes account of a capital conservation buffer in the amount of 1.25%, while in the right figure the figure is 2.5% together with an O-SII buffer. The recapitalisation requirement does not include capital buffers, while the P1 and P2 requirements are taken into account in a specific ratio of between 0% and 100%. In the first case the MREL-eligible instruments include own funds, and subordinated debt and senior unsecured debt with at least 12 months remaining on their terms (MREL), while in the second case they include all debt instruments eligible as a bail-in tool whose residual maturity is at least 12 months (eligible for resolution; maturity > 1y).

Source: Bank of Slovenia

In addition to the MREL requirements' dependence on the capital requirements, the restrictions on when the resolution fund can participate in the resolution of a bank are also important. This entails a restriction that MREL-eligible instruments amount to at least 8% of total assets or 20% of risk-weighted assets. The update to the BRRD harmonises the MREL requirements for globally systemically important institutions with the TLAC requirements. Their MREL-eligible instruments must reach a level of 16% of risk-weighted assets or at least 6% of leverage exposures by 2019, and 18% of risk-weighted assets or at least 6.75% of leverage ratio exposures by 2022. The restrictions for globally systemically important institutions are less relevant to Slovenian banks, and are included for orientation purposes only.

Figure 2.46: Estimated shortfall in MREL-eligible instruments with regard to certain floors tied to total assets, leverage ratio exposure and risk-weighted assets, in EUR million



Note: In the first case the MREL-eligible instruments include own funds, and subordinated debt and senior unsecured debt with at least 12 months remaining on their terms (MREL), while in the second case they include all debt instruments eligible as a bail-in tool whose residual maturity is at least 12 months (eligible for resolution; maturity > 1y).

Source: Bank of Slovenia

The estimated potential shortfall in MREL-eligible instruments at Slovenian banks shows the floors tied to capital requirements to be more restrictive than those tied to total assets and leverage ratio exposure. Alongside high levels of capital adequacy, systemically important banks have sufficient MREL-eligible instruments, for which reason there is no expectation of them facing a shortfall. They would have a shortfall in eligible instruments in the event of full application of capital buffers as envisaged in 2019, should the requirements on the basis of Pillar 2 remain unchanged. However, the profit generated over the first eleven months of this year exceeds the estimated shortfall. This means that even stricter requirements could be met through retained earnings, without the search for additional funding on the market or recapitalisation. The estimated shortfall in MREL-eligible instruments at the subsidiary banks is primarily larger in the event that in the MREL recapitalisation requirement they would have to cover the requirements under Pillar 1 and Pillar 2, or attain an MREL in the amount of 20% of risk-weighted assets. In both cases the shortfall exceeds EUR 100 million, while in other cases the shortfall is significantly smaller. At the subsidiary banks MREL-eligible instruments will be provided by the parent banks at group level, and there is no expectation that the subsidiary banks would have to seek funding themselves on the financial markets. Under comparable criteria, the small banks record the largest shortfall in MREL-eligible instruments. However, given the lower systemic importance of these banks, their MREL requirements are also smaller, and will be met through unsecured debt in addition to own funds.

Despite the indisputable positive effects on financial stability from meeting the MREL requirements, it is important that the actual process of meeting the requirements does not introduce instability into the system. It is therefore necessary to take account of the banks' capacity to obtain eligible funding on the market, and the market's capacity to absorb such instruments. One of the key aspects of MREL will be the requirements with regard to the amount of subordinated instruments included. It is important that the banks meet the majority of the MREL requirements through own funds and subordinated instruments, as only they provide adequate protection for depositors. Timely collateral requirements by other creditors could exclude senior unsecured debt from bail-in, which increases the structural subordination of deposits. At the same time meeting the MREL requirements primarily through own funds and subordinated instruments hinders banks' operations, particularly generating sufficient returns to cover the costs of such funding in an environment of zero interest rates. Because all eligible assets would be included in the event of bank resolution through bail-in, it is reasonable that they be taken into account when the MREL requirements are being met. Meanwhile the banks are only gradually focusing on shifting the structure of MREL-eligible instruments towards greater subordination.

3 NON-BANKING FINANCIAL INSTITUTIONS

Summary

The development of credit intermediation outside of the banking sector, so-called shadow banking, increases with the development of capital markets, which has a positive impact on economic activity. The economic crisis also revealed the negative side of shadow banking, when deficient supervision had an adverse impact on the financial stability of economies. Because of the poorly developed domestic capital market, shadow banking in Slovenia is also developing more slowly than elsewhere in Europe. The main source of shadow banking in Slovenia consists of money-market and bond investment funds and other financial entities (other than insurance corporations and pension funds). The size of the shadow banking sector in Slovenia was estimated at EUR 5.5 billion in June 2016, or 8% of the financial system's total financial assets. Shadow banking in Slovenia declined in the past, primarily as a result of the contraction in leasing business and the winding-up of numerous financial holding companies in the first five years after the outbreak of the economic crisis.

Despite positive growth in gross insurance premium and a decline in the claims ratio, insurance corporations' net profit over the first nine months of 2016 was down in year-on-year terms. The decline was attributable to aggressive competition, which is increasing the pressure on prices in general insurance and life insurance, and lower capital gains on financial assets. The insurance sector's capital adequacy remains at a high level. On the day that Solvency II came into effect, the capital adequacy of the insurance system as a whole exceeded the capital adequacy defined under Solvency I. In the low interest rate environment the quest for higher returns is prompting insurance corporations to increase their investments in higher-risk securities and at longer maturities, which is increasing investment risk and refinancing risk.

The banking sector's interest in leasing business is increasing in the low interest rate environment. The last 12 months have already seen a second transfer of leasing business to one of the commercial banks. The stock of leasing business at the commercial banks accounted for 5.9% of the total stock of business at leasing companies at the end of September 2016. Economic growth is having a positive impact on the leasing sector, which has been reflected in an increase in new leasing business and positive performance by leasing companies, which generated record profits over the first nine months of the year. Equipment leasing business is strengthening in particular, primarily for cars and commercial vehicles. Real estate leasing business also began strengthening in 2016, although the small volume meant that it had a minimal impact on the performance of leasing companies. The quality of leasing business is gradually improving, which is being reflected in a decline in the proportion of claims more than 90 days in arrears.

In the low interest rate environment investors on the capital markets are seeking instruments that provide higher returns. They have therefore retained an appetite for investments in shares even in 2016, when stock markets have been shaken by a number of events. Demand for debt securities also remains high, thanks to the continuation of expansionary monetary policy. The gradual strengthening of inflationary expectations and the gradual scale-back of expansionary monetary policy could trigger stronger pressure to sell debt securities, which would have an adverse impact on the performance of the sectors whose investment policy most exposes them to such investments (pension funds, insurance corporations, bond funds). The domestic capital market remains unattractive to potential new issuers of securities, which has been reflected in a contraction in issuance of shares on the domestic stock market. Issuance of debt securities has strengthened slightly, although the number of issuers remains limited to those who have made use of such borrowing in the past. The lack of development of the domestic capital market remains the main reason that this source of financing remains unexploited by non-financial corporations.

3.1 Shadow banking

The development of credit intermediation outside the banking system is welcome, because it increases the diversification of the financial system. An advanced credit intermediation market increases the diversification and accessibility of financial resources, which can have a positive impact on economic activity. Non-banking financial corporations, which usually account for the majority of credit intermediation outside banking, are less indebted than banks, and have less impact on maturity mismatching between assets and funding. All of this also has a beneficial impact on financial stability, because in this manner greater diversification can be achieved in the risks of credit intermediation. It was nevertheless demonstrated in the last financial crisis that credit intermediation outside banking can also have an adverse impact on financial stability. It is therefore so much more important that, for the purposes of financial stability, credit intermediation be addressed comprehensively, which entails the establishment of adequate supervision even outside banking.[37]

Definition of shadow banking

Shadow banking consists of all entities that pursue one or more credit intermediation activities, and are not regulated, i.e. are not subject to appropriate supervisory and regulatory arrangements. The most common forms of shadow banking include factoring and leasing companies, money-market funds, hedge funds, fixed income funds, real estate funds, and SPVs involved in securitisation transactions.

Financial Stability Board at the BIS (FSB)

The FSB defines shadow banking in narrower and broader senses. In the broader sense it defines it as the system of credit intermediation that involves entities and activities outside the regulated banking system. These are individual institutions (banking transactions) and entire credit intermediation chains. In the narrower sense it is the system of credit intermediation that is a potential source of systemic risk because of maturity and liquidity transformation.

Given the complexity of monitoring shadow banking, the FSB has developed a monitoring methodology based on two intertwined pillars:

- The *first pillar (broad approach)* consists of the oversight of entities engaged in credit activity outside the conventional banking system. The purpose of the broad definition is monitoring the entire financial system to identify potential risks to financial stability.
- The *second pillar (narrow approach)* consists of the targeted oversight of activities that increase financial risks, such as credit risk transfer, maturity and/or liquidity transformation, and the use of direct or indirect leverage.

For the purposes of the implementing the second pillar, the FSB has divided entities under the first pillar into *five key economic functions*:[38]

- collective investment undertakings susceptible to runs;
- loan provision dependent on short-term funding;
- intermediation of market activities dependent on short-term funding;
- facilitation of credit creation outside the conventional banking system;
- securitisation-based credit intermediation and credit guarantee issuance.

European Systemic Risk Board (ESRB)

To ensure greater consistency with the definition and methodology proposed by the FSB, the ESRB is focusing primarily on assessment of the risk to financial stability presented by shadow banking activity in the EU. Consequently the ESRB has developed its own methodology for the oversight of shadow banking based on the supervision of entities and activities, similarly to that defined by the FSB methodology.

Oversight of entities

This is based on the aggregation of balance sheet data of financial entities taken from financial accounts, and is further divided into the following (similarly to the FSB definition):

- The *broad approach*, which includes all financial sector entities except banks, insurance corporations and pension funds that could potentially pose risks to the financial sector. The aim of the broad approach is to cover all areas of shadow banking where risks that could endanger the entire financial system might potentially develop.
- The *narrow approach* is based on the identification of entities whose activities pose greater systemic risk. It highlights entities whose activities are related to credit

[37] Source: ESRB, Macroprudential policy beyond banking: an ESRB strategy paper, July 2016.
[38] The FSB introduced the economic functions approach in 2015.

intermediation, liquidity and maturity transformation, leverage and interconnectedness with the banking system.

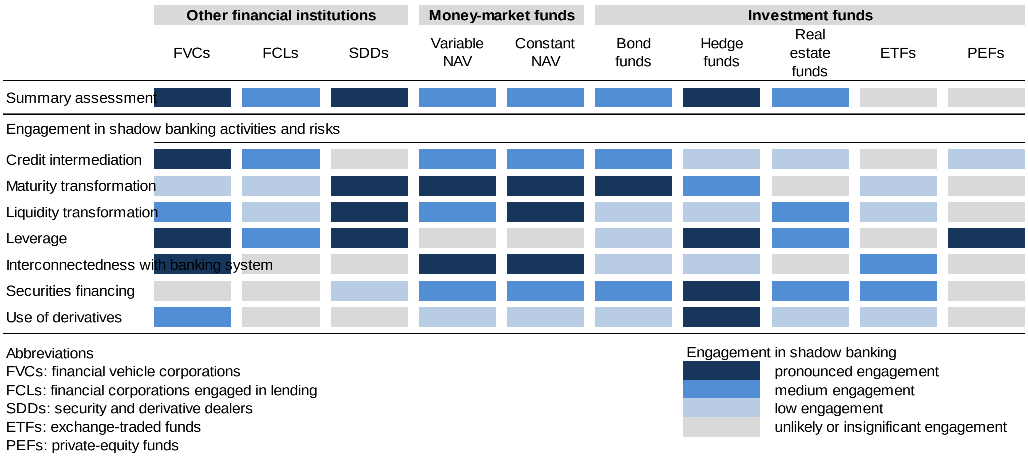
Oversight of activities

In contrast to the broad approach, oversight of activities is not confined solely to individual entities belonging to a specific sector, as it also monitors other activities of entities that increase the interconnectedness of the financial system (via derivatives, repo transactions, securities lending, FVCs and SPVs).

The purpose of oversight of activities is to ensure comprehensive coverage of shadow banking, as all areas of financing are covered. Oversight of activities is a complementary approach to oversight of entities, and ensures oversight of all the segments that constitute shadow banking (the greatest limitation is the availability of data). The complementary approach ensures that insurance corporations and pension funds, which as entities do not fall directly under the system for oversight of shadow banking, are included indirectly in oversight because of their potential activities.

The table below illustrates the links between activities and the risks inherent in shadow banking, as compiled by the ESRB. The table makes evident that the greatest risks inherent in shadow banking are (1) companies engaged in the transfer of financial assets and involved in securitisation deals, (2) security and derivative dealers, and (3) hedge funds.

Table 3.1: Shadow banking: general illustration of links between sectors, activities and risks[39]



Source: ESRB

Presence of shadow banking in the Slovenian economy

The financial assets of monetary financial institutions have continued to gradually decline as a result of the contraction in credit activity. The Slovenian financial system's total financial assets stood at 180% of GDP at the end of June 2016, down 1.3% in year-on-year terms. Despite a decline in their share of the financial system as a whole, monetary financial institutions still account for just over 57% of total financial assets. Non-monetary financial institutions' financial assets stood at just over EUR 17 billion in June 2016, a similar level to the two previous years. Insurance corporations and pension funds recorded positive year-on-year growth in financial assets, while other sectors saw a slight decline.

Table 3.2: Financial assets of the Slovenian financial sector

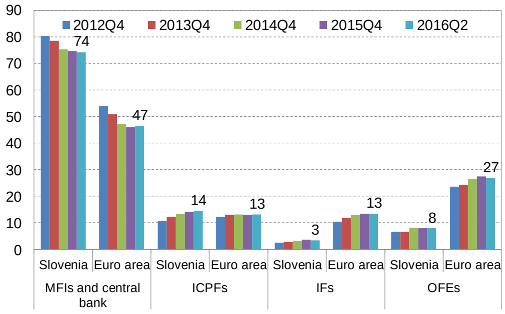
	Financial assets, EUR million			Breakdown, %			Ratio to GDP, %			Growth, %		
	2014	2015	2016 Q2	2014	2015	2016 Q2	2014	2015	2016 Q2	2014	2015	2016 Q2
Monetary financial institutions	42.306	40.382	38.849	59,9	59,4	57,5	116,8	109,0	103,6	-5,8	-4,5	-4,8
Central bank	10.900	10.275	11.262	15,4	15,1	16,7	30,1	27,7	30,0	0,9	-5,7	15,3
Non-monetary financial institutions	17.368	17.325	17.435	24,6	25,5	25,8	48,0	46,8	46,5	14,1	-0,2	-2,3
insurance corporations	7.031	6.999	7.247	10,0	10,3	10,7	19,4	18,9	19,3	8,6	-0,5	1,8
pension funds	2.339	2.487	2.546	3,3	3,7	3,8	6,5	6,7	6,8	9,4	6,3	4,8
investment funds other than MMFs	2.245	2.393	2.339	3,2	3,5	3,5	6,2	6,5	6,2	19,0	6,6	-6,6
other financial institutions	5.754	5.446	5.303	8,2	8,0	7,9	15,9	14,7	14,1	21,8	-5,3	-8,5
Total	70.575	67.982	67.545	100,0	100,0	100,0	194,9	183,5	180,1	-0,5	-3,7	-1,3

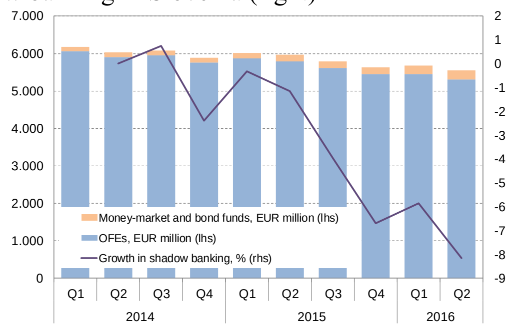
Source: Bank of Slovenia

[39] Source: EU Shadow Banking Monitor, No 1, ESRB, March 2016.

The poorly developed capital market in Slovenia is having a significant impact on the development of the entire financial system, which is reflected in the high concentration of assets in the banking system. Slovenian monetary financial institutions (including the central bank) accounted for 74.2% of the financial system's total financial assets at the end of the second quarter of 2016, compared with a figure of 46.6% across the euro area. The proportions accounted for by investment funds and other financial institutions also deviate to a great extent from the euro area average, at just 3% and 8% respectively.

Figure 3.1: Structure of financial assets of selected sectors in Slovenia and the euro area, in percentages (left), and size of shadow banking in Slovenia (right)





Notes: IFs: investment funds; ICPFs: insurance corporations and pension funds; OFEs: other financial entities (excluding insurance corporations, pension funds and investment funds); MFIs: monetary financial institutions, including the central bank (for reason of data comparability).
* Growth relative to Q2 2014.

Sources: ECB (SDW), own calculations

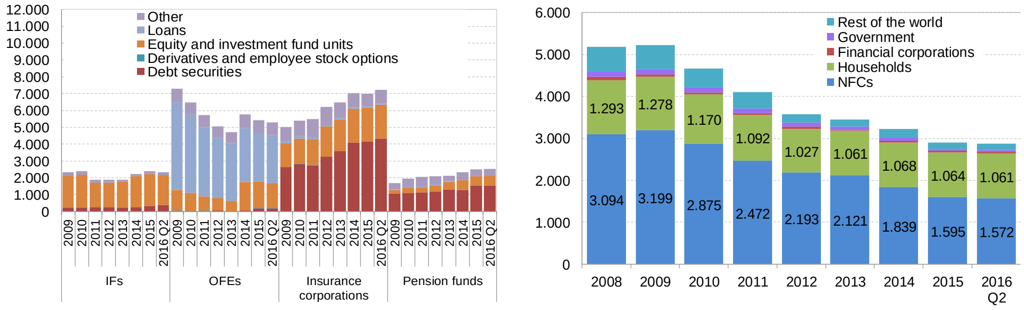
Shadow banking in Slovenia has contracted in the period since the economic crisis as a result of the contraction of business in finance and operating leasing and the collapse of financial holding companies. The financial assets of the shadow banking in Slovenia were estimated at EUR 5.5 billion in June 2016, down 7% in year-on-year terms. Shadow banking in Slovenia consists primarily of leasing companies, financial and mixed-activity holding companies, and other entities. Together they constitute other financial entities, and account for the majority of shadow banking in Slovenia. Only a minority of shadow banking in Slovenia consists of money-market and bond funds, while other sectors and activities from the table above are not defined in detail, because either they do not exist or are not recorded in Slovenia.

In accordance with the definition of shadow banking, investment funds that are neither bond funds nor money-market funds are excluded from further discussion. The net financial assets of domestic investment funds of significance to shadow banking have thus been reduced by 90% from EUR 2.3 billion to EUR 0.2 billion as at the end of the second quarter of 2016, open-end equity funds (60%) and open-end mixed funds (30%) having accounted for the majority of the net financial assets.

If insurance corporations and pension funds, which as entities are not classed as shadow banking according to the definition, are also excluded from the comprehensive overview of the financial system, the majority of potential shadow banking activities remain in the category of other financial entities. According to a broad assessment,[40] these can be divided into undertakings engaged in renting and leasing (leasing companies), which account for 56% of the other financial entities sector, financial holding companies (27%) and other undertakings (17%). The majority of the last group consists of undertakings engaged in various financial and insurance activities that are not directly classified under the insurance sector.

[40] A more precise demarcation cannot be given on the basis of financial accounts. The assessment is based on data from various sources, which can result in anomalies from the true situation.

Figure 3.2: Breakdown of financial assets of selected sectors (left), and loans made by OFEs to other sectors (right), in EUR million



Source: Bank of Slovenia

It is evident from the above figure that the largest credit intermediation activity comes from the category of other financial entities (OFEs), which is primarily attributable to the size of leasing companies. There was a pronounced trend of contraction in financial assets at OFEs between 2009 and 2013, when numerous holding companies closed down in the economic crisis, and because of the negative trend on the domestic stock market, which had an adverse impact on the value of investments in equities and investment fund units. The economic crisis also brought a decline in the assets of leasing companies, where the largest contraction was in real estate business.[41] The contraction in the financial assets of OFEs also led to a contraction in lending activity, which hit the non-financial sector hardest.

The non-financial sector accounted for 55% of the stock of loans made by OFEs at the end of June 2016, unchanged from the end of 2015. The stock of loans to the non-financial sector stood at EUR 1.6 billion, down 10.3% in year-on-year terms as a result of the contraction in real estate leasing activity. The second-largest loan recipient was the household sector, which accounted for 37% of the total stock of loans in June 2016, up 0.3 percentage points on the end of 2015.

It can be determined from the available data that the proportion of entities and activities that pose the largest shadow banking risks is small, as the individual activities are not yet very developed in Slovenia.

3.2 Leasing companies

Leasing companies' turnover[42]

The banking sector's interest in leasing business is increasing in the low interest rate environment. The last 12 months have already seen a second transfer of leasing business to one of the commercial banks. The new leasing business concluded by commercial banks over the first nine months of 2016 amounted to EUR 71 million, or 10% of total leasing business generated over the same period by leasing companies. The stock of leasing business at the commercial banks amounted to EUR 159 million at the end of September 2016, or 5.9% of the total stock of business at leasing companies.

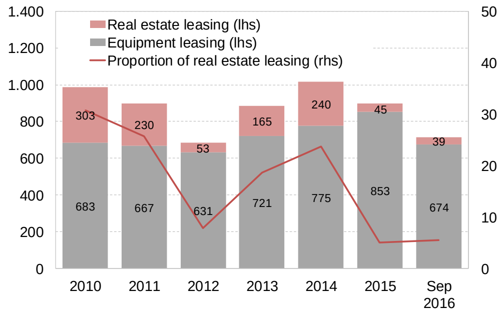
New leasing business over the first nine months of the year was up 9.6% in year-on-year terms at EUR 712 million, as a result of the continuing positive trend in equipment leasing and a positive shift in the real estate market. Equipment leasing was prevalent: new equipment leasing business was up 9.4% at EUR 674 million. The increase in real estate leasing business was slightly larger, at 12.8%, albeit to merely EUR 38 million.

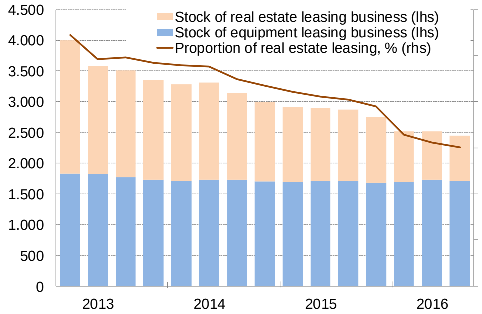
Cars and commercial and freight vehicles account for the majority of new equipment leasing business. Leasing business in the aforementioned categories over the first nine months of the year was up 10.8% in year-on-year terms at EUR 605 million, and accounted for 89.7% of total new equipment leasing business. The positive trend has continued in this segment, albeit slightly more slowly than in the same period of 2015, when growth of 11.6% was recorded. The LTV for

[41] All leasing business is treated as loans in this section.
[42] In the third quarter of 2016 another commercial bank entered the leasing market, and began transferring leasing business from leasing companies into its business model, which has had a negative impact on the reported values, as commercial banks are not required to report leasing business.

equipment leasing remains stable at 79.8%. The increase in real estate leasing was attributable to commercial real estate leasing, which was up 16% in year-on-year terms and accounted for the majority of new real estate leasing business. Real estate leasing business nevertheless remains at a low level, at EUR 26 million. The LTV for real estate leasing was up 2 percentage points in year-on-year terms at 99%.

Figure 3.3: New leasing business[43] and proportion accounted for by real estate leasing (left), and stock of leasing business and proportion accounted for by real estate leasing (right), in EUR million and percentages





Source: Bank of Slovenia

The trend of contraction in the stock of leasing business has continued in 2016, which was attributable to a contraction in real estate leasing business. The total stock of leasing business amounted to EUR 2.5 billion in September 2016, down 14.6% in year-on-year terms. The stock of real estate leasing business was down 36.3% in year-on-year terms at EUR 739 million.[44] The main factor in the contraction in the stock of real estate leasing business was a lack of major real estate projects, particularly in the area of commercial real estate, which accounted for the majority of real estate leasing business in the past. By contrast, despite the transfer of certain business to commercial banks, the stock of equipment leasing business recorded a slight year-on-year increase of 0.1% to EUR 1.7 billion, thereby continuing the positive trend in this segment.

The stable performance in equipment leasing is continuing to shift the focus in leasing business from real estate to equipment. Leasing of cars and commercial and freight vehicles is providing for the stable growth in the stock of leasing business. The stock of leasing business for cars was up 4.5% in year-on-year terms at EUR 965.8 million, while the stock of leasing business for commercial and freight vehicles was up 11.2% at EUR 468 million. The stock of other equipment leasing business was down 23.8% over the same period at EUR 280 million, which almost entirely neutralised the increase in equipment leasing. As a result the proportions of the total stock of equipment leasing business accounted for by cars and by commercial and freight vehicles increased by 2 percentage points and 3 percentage points to 56.4% and 27.3% respectively.

The quality of leasing business is gradually improving. The proportion of claims more than 90 days in arrears stood at 9.6% in September 2016, down 0.7 percentage points in year-on-year terms. In equipment leasing the proportion of claims more than 90 days in arrears declined by 2.3 percentage points to 6.3%, while in real estate leasing the proportion of claims more than 90 days in arrears increased by 4.4 percentage points to 17.1%, primarily as a result of a faster contraction in the stock of real estate leasing business than in the claims more than 90 days in arrears.

Financing of selected institutional sectors

The non-financial corporations sector and household sector accounted for 97.3% of the total stock of leasing business at the end of the third quarter of 2016, or EUR 2.4 billion in total.

Leasing companies' exposure to the non-financial corporations sector stood at 55.4% of the total stock of leasing business in September 2016, down 4.1 percentage points in year-on-year terms. The contraction in exposure to non-financial corporations is the result of the continuing

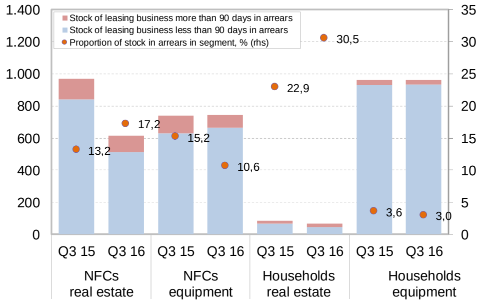
[43] Owing to data availability, in this entire section leasing business since 2010 has been disclosed at financed value, excluding the financing of inventories. All business with residents of Slovenia is included in the analysis.

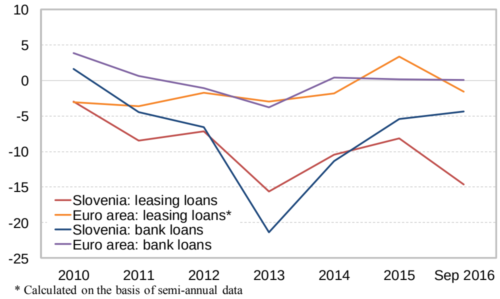
[44] The contraction in the stock of real estate leasing business activities was attributable to an accounting revision in the amount of EUR 130 million in the reporting of one leasing company in the first quarter of 2016, and the transfer of business from another leasing company to a commercial bank at the end of 2015. Eliminating these two factors, the stock of leasing business in September 2016 would have contracted by less in year-on-year terms, namely 21%.

negative trend in real estate leasing, while equipment leasing business strengthened by 0.3% in year-on-year terms to EUR 743 million. If the leasing business transferred to commercial banks were included, non-financial corporations' exposure to financing at leasing companies would be slightly higher. Non-financial corporations' equipment leasing business for commercial and freight vehicles amounted to EUR 319 million over the first nine months of the year, up 22% in year-on-year terms, while their leasing business for cars was up 7% at EUR 216 million. The stock of other equipment leasing business contracted, similarly to real estate leasing.

The total proportion of claims against the non-financial corporations sector more than 90 days in arrears declined by 0.4 percentage points in year-on-year terms to 13.6%. The stock of claims more than 90 days in arrears contracted by 23% to EUR 185 million, while the total stock of leasing business with non-financial corporations contracted by 21% to EUR 1.4 billion.

Figure 3.4: Stock and proportion of leasing business more than 90 days in arrears, in EUR million and percentages (left), and year-on-year growth in stock of leasing business and bank loans to the non-banking sector, in percentages (right)





Sources: ECB, Leaseurope, BAS, Bank of Slovenia, own calculations

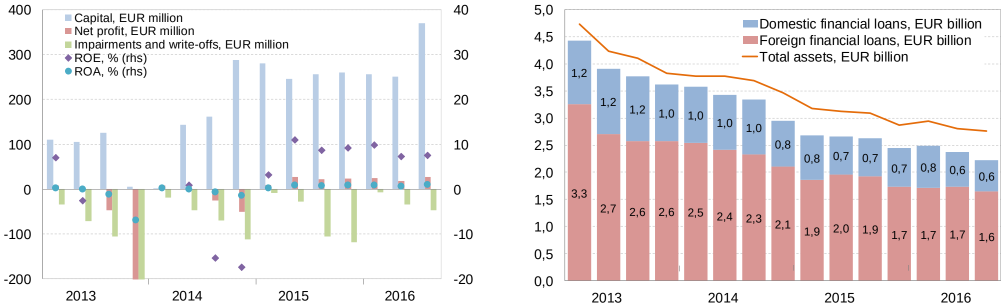
The household sector accounted for 41.9% of the total stock of leasing business at the end of the third quarter of 2016. The stock of leasing business with the household sector stood at EUR 1.03 billion in September, down 1.9% in year-on-year terms, although the larger contraction in leasing business with non-financial corporations meant that the proportion of total leasing business accounted for by households increased by 4.4 percentage points. The proportion of claims against households more than 90 days in arrears was up 0.5 percentage points in year-on-year terms at 4.7%. The main factor in the decline in this figure was the contraction in claims more than 90 days in arrears in equipment leasing and a simultaneous increase in the stock of equipment leasing business, in which leasing business for cars was prevalent. Claims more than 90 days in arrears in real estate leasing remain unchanged, while the stock of real estate leasing business contracted, which brought an increase in the proportion of real estate leasing claims more than 90 days in arrears in the third quarter.

Leasing companies' performance

Leasing companies have remained profitable in 2016. They recorded a net profit of EUR 28 million over the first three quarters of the year, the largest figure of recent years. Net profit was up 25.4% in year-on-year terms, largely on account of a decline in impairments. Despite a minor positive revision, ROA remains at a level of 1%, while ROE in September 2016 was down 1.2 percentage points in year-on-year terms at 7.5% as a result of the recapitalisation of individual leasing companies by foreign owners. Recapitalisation took leasing companies' total equity to its highest value of the last four years (EUR 369 million). In the wake of the increase in equity and a decline in operating and financial liabilities, leverage[45] at the end of the third quarter of 2016 was down 4.3 percentage points in year-on-year terms at 6.2%.

[45] The ratio of leasing companies' operating and financial liabilities to their equity.

Figure 3.5: Selected performance indicators (left), and leasing companies' funding (right)



Note: A net loss of EUR 266 million was recorded in the final quarter of 2013, which sharply reduced equity. ROA and ROA were therefore strongly negative during this period.
Source: Bank of Slovenia

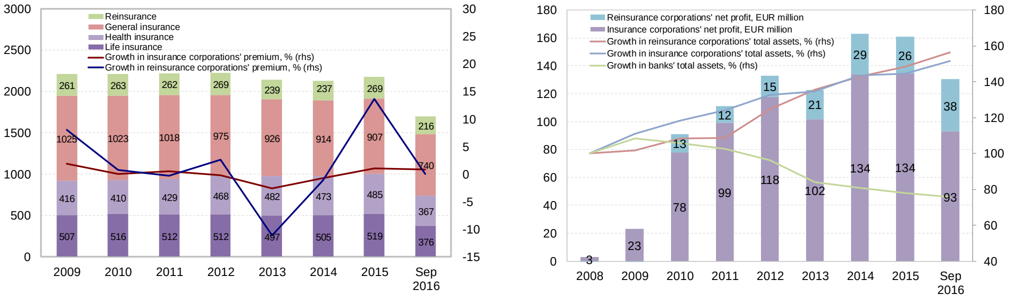
Financial loans from the rest of the world remain the principal source of funding for leasing companies. They amounted to EUR 1.6 billion in September 2016, equivalent to 73.9% of total financial loans. The stock of foreign loans was down 14.8% in year-on-year terms, while the stock of domestic loans was down 16.6% at EUR 581 million.

3.3 Insurers

Features of insurers' performance

Gross written premium continued to record positive growth at insurance corporations in 2016, while it was unchanged at reinsurance corporations. Insurance corporations'[46] gross written premium over the first nine months of the year was up 0.9% in year-on-year terms. This was attributable to growth in health and pension insurance, while changes in policyholders' habits again brought a decline in gross written premium in life insurance.

Figure 3.6: Gross written premium by type of insurance, in EUR million, and annual growth, in percentages (left), and net profit, in EUR million, and index (2008 = 100) of total assets (right)



Sources: ISA, Bank of Slovenia

Insurance corporations' total assets in September 2016 were up 5.1% at EUR 7 billion, while reinsurance corporations' total assets were up 3.9% at EUR 875 million. The increase in insurance corporations' total assets was attributable to an increase in total assets in the segments of life insurance and general insurance.

Insurance corporations generated a net profit of EUR 92.9 million over the first nine months of the year, down 15.4% on the same period of 2015. The deterioration in performance was attributable to a decline in net profit from general insurance and life insurance. The number of insurance corporations recording a loss increased by one. There were four loss-making insurance corporations in the general insurance segment, and three in the life insurance segment. Reinsurance corporations recorded a net profit of EUR 37.5 million over the first nine months of the year, up 20.5% in year-on-year terms. This was attributable to a year-on-year increase in income from insurance premiums, and a simultaneous slight decline in claims expenses.

[46] The number of reporting entities increased by one in 2016.

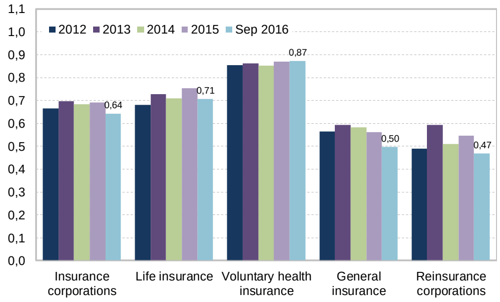
Capital adequacy

The Directive on the taking-up and pursuit of the business of insurance and reinsurance (Solvency II) entered into force on 1 January 2016. On the first day following the introduction of Solvency II, the capital of the insurance sector as a whole amounted to EUR 1.5 billion, or 161% of the total solvency capital requirement.[47] The insurance sector's capital adequacy was thus higher than under the rules of Solvency I at the end of 2015, when the surplus in available capital over the minimum capital requirement stood at 157%.

Underwriting risk

The claims ratio as measured by the ratio of gross claims paid to gross written premium over the first nine months of 2016 was down 0.02 index points in year-on-year terms at 0.64. Insurance corporations' claims paid were down 1.5%, while written premium was up 0.9%. The sole deterioration in the claims ratio was in the voluntary health insurance segment, where claims paid increased more than gross written premium. In the general insurance segment, which accounts for 50% of total written premium, written premium was up 2.3%, while claims paid were down 1.1%. The life insurance segment recorded a decline in both written premium and claims paid.

Figure 3.7: Claims ratio for major types of insurance



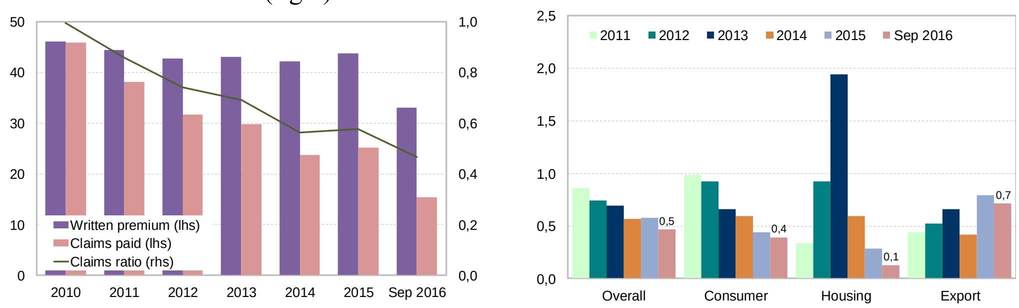
Source: ISA

Like insurance corporations, reinsurance corporations also improved their claims ratio in the first nine months of the year. This was attributable to an increase in gross written premium and a decline in claims paid in 2016.

Influence of insurers on the stability of the banking sector via credit insurance

The claims ratio from credit insurance over the first nine months of 2016 declined in year-on-year terms to 0.47, primarily as a result of a decline in claims paid and an increase in written premium. Written premium was up 3.6% at EUR 33.1 million. The growth in written premium was attributable to increases of 7.4% in written premium in consumer credit insurance, to EUR 12.3 million, and 34% in written premium in housing credit insurance, to EUR 2.9 million. The trend of contraction continued in written premium in export credit insurance, which is the second-largest source of premium. Export credit insurance premium amounted to EUR 8.7 million over the first nine months of the year, down 9.1% in year-on-year terms.

Figure 3.8: Written premium and claims paid, in EUR million (left), and claims ratio for credit insurance (right)



Source: ISA

[47] Source: SIA, Statistical Insurance Bulletin 2016

Credit insurance claims paid amounted to EUR 15.4 million over the first nine months of the year, down 19% in year-on-year terms. Claims declined in all the major types of credit insurance, which had a positive impact on the claims ratio. Claims paid in export credit insurance, which account for the largest proportion of claims, declined by 20% to EUR 6 million, while claims paid in consumer credit insurance declined by 9.4% to EUR 4.8 million.

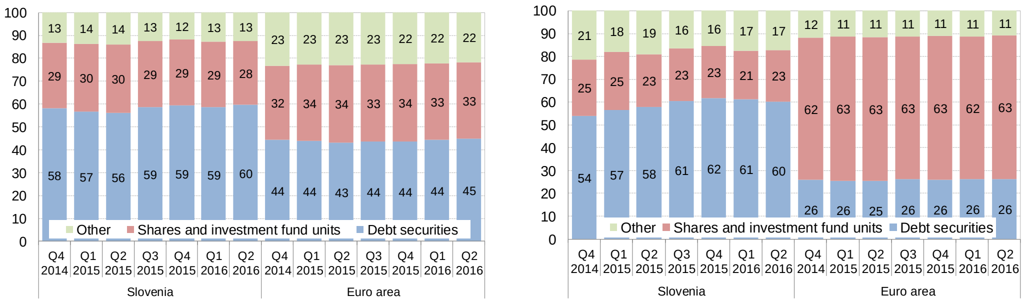
Investment risk

Insurance corporations' income from investments over the first nine months of the year was down 15.7% in year-on-year terms. The exceptional growth in income in 2015 was attributable to an increase in income from affiliates. The situation on the capital markets has had a significant impact on returns on financial assets this year. Low or zero interest rates have had a negative impact on the return on investments in bonds, which account for 60% of insurance corporations' total investments, while there has been great volatility on stock markets.

Reinvestment risk is increasing in the low interest rate environment. The ongoing fall in interest rates is above all making it harder for insurance corporations to match assets and liabilities. However insurance corporations' performance is based on stable cash flows from insurance policies, which provide a stable, long-term cash flow that is not dependent on the low interest rate environment to the same degree that the commercial banks are. As a result the possibility of contagion within the financial system is significantly smaller.

Despite the continuation of the trend of increase in investments in foreign securities, the insurance sector has maintained a significant role in purchases of domestic debt security issues. The Slovenian insurance sector's investments in debt securities amounted to EUR 4.3 billion at the end of June 2016, or 59.8% of insurance corporations' total financial assets, while the corresponding structure at insurance corporations across the euro area is more balanced, with a figure of 45%. In the quest for higher returns and diversification of the investment portfolio, insurance corporations are switching to foreign securities. Investments in domestic debt securities thus stood at EUR 1.3 billion in June, down 7.2%. Investments in domestic shares and investment fund units were down 13%, while investments in foreign securities (primarily foreign bonds) stood at EUR 3.7 billion in June, up 12.3% in year-on-year terms.

Figure 3.9: Comparison between Slovenia and euro area of percentage breakdown of financial assets of insurance sector (S.128; left) and pension fund sector (S.129; right)

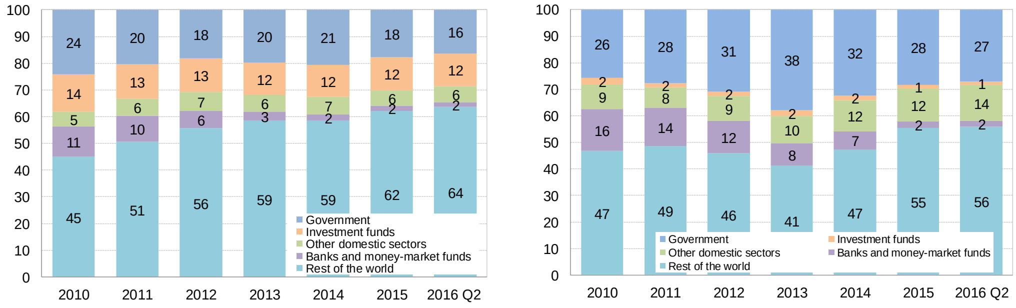


Sources: ECB, Bank of Slovenia

Investment structure in the pension funds sector is gradually changing to become more balanced, as a result of the introduction of lifecycle funds. Debt securities nevertheless remain the predominant form of financial assets held as an investment.

Both insurance corporations and pension funds are increasing their investments in the rest of the world, and are reducing their exposure to domestic government securities. Insurance corporations held 64% of their investments in foreign assets at the end of the second quarter of 2016, while pension funds held 56%. The change in investment policy means that both sectors are becoming more exposed to developments on foreign markets.

Figure 3.10: Percentage of investments by the insurance sector (left) and pension funds (right) in shares, investment fund units and debt securities by institutional sector



Source: Bank of Slovenia

According to SMA data,[48] the trend of growth in mutual pension funds' assets under management has continued in 2016, when they surpassed the mark of EUR 1 billion. Mutual pension funds' assets under management stood at EUR 1.01 billion in September, up 4.7% in year-on-year terms. The trend of increase in the number of members of mutual pension funds has also continued: it stood at 263,984 in September, up 3.6% in year-on-year terms.

Pension agencies, which fall under the oversight of the ISA,[49] are also recording further growth in assets. Their assets under management stood at EUR 664 million in September 2016, up 9.4% in year-on-year terms. The number of voluntary supplementary pension insurance policyholders is also gradually rising: it stood at 130,068 in September, up 2% in year-on-year terms.

3.4 Capital market

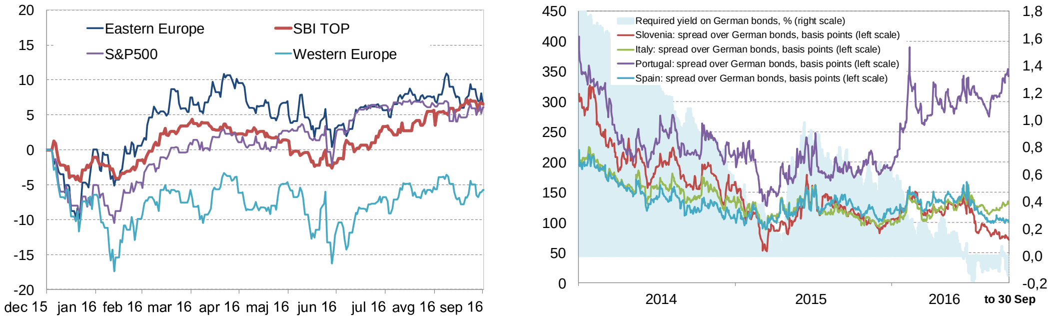
Developments on the capital market

In the low interest rate environment investors are seeking instruments that provide higher returns. They have therefore retained an appetite for investments in shares even in 2016, when stock markets have been shaken by numerous factors. Movements in stock market indices were consequently uneven over the first nine months of the year. The difficulties in the European banking sector and speculation about the outcome of the UK referendum in late June had a profound impact on developments on stock markets in western Europe. The composite stock market index for western Europe[50] nevertheless ended September unchanged in year-on-year terms, although it was down 5.8% over the first nine months of the year. The S&P 500 in the US ended September up 13% in year-on-year terms, but down slightly on its record high in August. The impact of the uncertainty caused by the US presidential election was also limited by the positive effects of growth in oil prices and the expectation that the Fed would act should it be necessary.

Developments in the spreads of 10-year government bonds over the German benchmark of comparable maturity indicate that ECB measures are restoring confidence to the higher-risk members of the euro area. The spreads widened in the first half of the year, as an indicator of the increased uncertainty caused by the UK referendum, but they narrowed again after the UK's decision to leave the EU. The sole exception was Portugal, where the spread increased sharply in 2016 as a result of the low economic growth projected for this year and next year, and the related potential downgrading.

[48] Covers three pension fund operators and nine mutual pension funds.
[49] Covers three pension agencies.
[50] The stock market index for western Europe includes east European countries in the euro area.

Figure 3.11: Change in selected stock market indices since the end of 2015, in percentages (left), and spread in selected 10-year government bonds over German benchmark bonds, in basis points, and required yield on German bonds, in percentages (right)



Sources: Bloomberg, own calculations

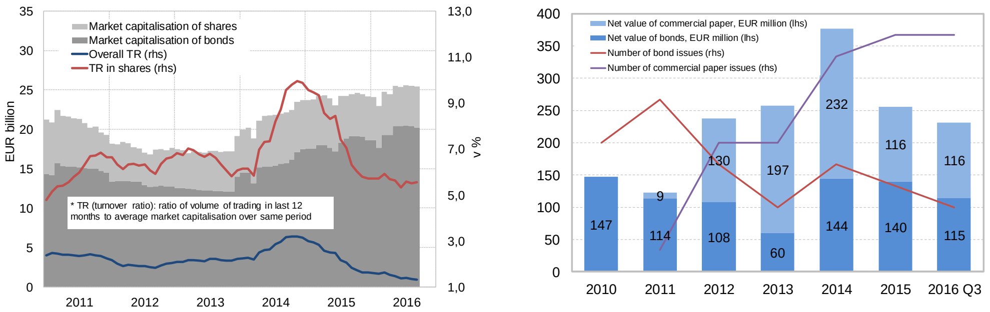
For investors whose investment policies commit them to investing mostly in debt securities (insurance corporations, pension funds, banks, etc.), the low interest rate environment is particularly increasing reinvestment risk and the risk of a sudden revaluation of debt securities. The election of a new president in the US and the increased expectations with regard to future developments in inflation (in the US and elsewhere around the world) have triggered selling pressure on the bond market, which is increasing the required yield on 10-year government bonds. The negative effect has been reflected in capital losses, which are reducing assets on investors' balance sheets.

Low liquidity and a fall in the number of share listings remain a constant on the domestic stock market. Six share issuers were delisted from the Ljubljana Stock Exchange over the first nine months of 2016. Only 41 share issuers remained in September. The market capitalisation of the delisted shares amounted to EUR 329 million at the end of 2015, or 6% of total market capitalisation at that time. The proportion of the market capitalisation of domestic shares held by non-residents declined by 2.5 percentage points over the first nine months of the year to 26.7%, primarily as a result of the delisting of takeover targets.

Despite the positive mood on the stock market in the first nine months of the year, when the SBIT TOP gained 6.5%, the market capitalisation of shares contracted by 5.1% over that period to EUR 5.2 billion. Without new action to improve the situation on the domestic capital market, the trend of the withdrawal of issuers from the Ljubljana Stock Exchange can be expected to continue. The latest change in the ownership of the Ljubljana Stock Exchange in 2015 has for the moment not had any positive impact, and the question is whether any can really be expected, in light of the negative trend in recent years. The cumulative volume of trading in shares over the first nine months of 2016 was down 16% in year-on-year terms, while the monthly volume of trading averaged EUR 23.5 million in 2016. The concentration of volume remains high: 66% of the total volume in shares related to just three firms listed on the prime market. Given the lack of liquidity and new share issues, the domestic stock market is becoming less and less attractive to strategic investors, the turnover ratio for shares has also declined to its lowest level since the beginning of 2011.[51] This leaves short-term investors on the stock market, who seek returns over the short term, which is additionally increasing the volatility on the domestic market.

[51] The sharp increase in the turnover ratio in 2014 was the result of the privatisation process, which brought a sharp increase in volume that year.

Figure 3.12: Market capitalisation on the Ljubljana Stock Exchange, in EUR billion, and annual turnover ratios (left), and issuance of corporate bonds and commercial paper (excluding the government sector), nominal values and number of issues (right)



Sources: LJSE, KDD, Bank of Slovenia

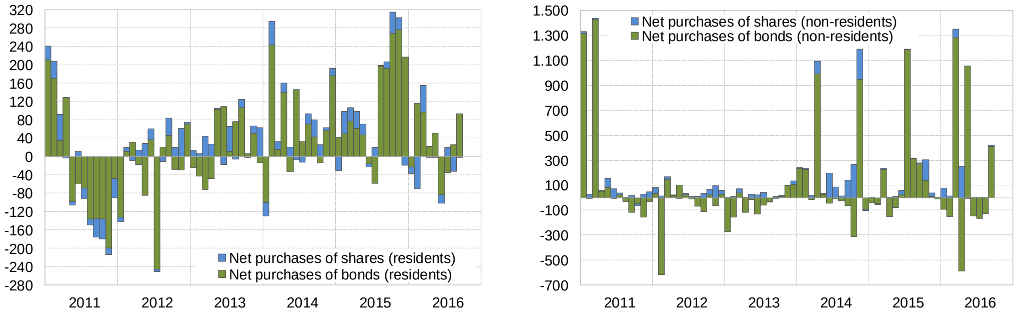
Total market capitalisation on the Ljubljana Stock Exchange (shares and bonds) increased over the first nine months of the year, primarily as a result of a new government bond issue and an increase in the value of corporate bond issues. Corporate bond issuance amounted to EUR 114.5 million over the first nine months of the year, up 27.4% in year-on-year terms. There were three issues during this period, the same as in the same period of 2015. The total market capitalisation of bonds increased by 5.3% in year-on-year terms to EUR 20.2 billion. Slovenian government bonds accounted for 94.5% of total bond issues, an indication of the Ljubljana Stock Exchange's dependence on the government's presence on the domestic stock market. The volume of trading in bonds amounted to EUR 13.6 million over the first nine months of the year, down 64.3% in year-on-year terms. Like shares, bond trading is also highly concentrated. Three bond issues accounted for 49.2% of the total volume of trading in the period in question.

Commercial paper issuance amounted to EUR 116.4 million over the first nine months of the year, up 55.12% in year-on-year terms. Commercial paper issuance was favoured by non-financial corporations, which accounted for 98% of total issuance. A total of 11 commercial papers were issued in this period, mostly by firms that had made use of such borrowing in the past.

Given the right functioning and oversight, a developed capital market successfully supplements traditional sources of financing, which can have a beneficial impact on economic activity in the country, but the situation on the Slovenian capital market is heading in the opposite direction. Fewer and fewer firms are opting to issue equities, while the favourable situation for issuing debt securities is mainly being exploited by firms that have previously been active in this area. To ensure the viability of the Slovenian capital market, it would be sensible to find a way to encourage existing and new firms to issue equities and debt securities.

Residents' net investments in foreign assets have declined in 2016. They amounted to EUR 203.5 million over the first nine months of the year, down 72.2% in year-on-year terms. The largest demand for foreign bonds came from insurance corporations and banks, whose net purchases of bonds amounted to EUR 145.2 million and EUR 99.2 million respectively. In the quest for higher returns insurance corporations and banks recorded net sales of bonds from euro area countries and net purchases of bonds from EU Member States outside the euro area. Insurance corporations also increased their exposure to US bonds. The largest net sellers of foreign shares were mutual funds and banks, who recorded sales of EUR 47 million and EUR 24.1 million respectively. Mutual funds primarily sold shares from the US, while banks sold shares from the UK. The household sector and non-financial corporations sector recorded net purchases of EUR 4 million and EUR 1 million respectively in foreign bonds, and net sales of EUR 5.6 million and EUR 4 million respectively in foreign shares over the same period.

Figure 3.13: Net outward investments by residents (left), and inward investments by non-residents (right), in EUR million



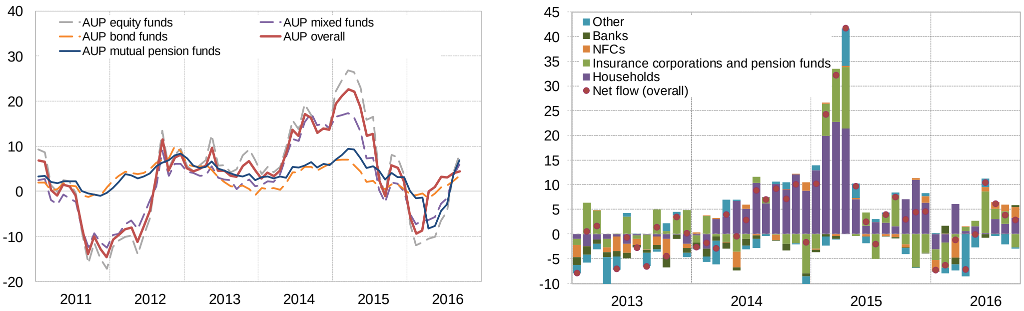
Sources: KDD, Bank of Slovenia

Non-residents purchased bonds worth EUR 1.5 billion and shares worth EUR 419 million over the first nine months of 2016. Slovenian bond purchases by non-residents were down 12.4% in year-on-year terms, while their net purchases of shares were up EUR 70 million at EUR 419 million as a result of the sale of Slovenian firms and consolidation of ownership by non-residents. Excluding takeovers, non-residents' investments in domestic shares would have declined by EUR 54 million. The lack of appropriate share investments on the stock market means that the trend of decline in non-residents' investments will only increase in the future. Non-residents' net investments in Slovenian bonds were notable in March, May and September, when the favourable situation meant that the finance ministry increased its issues of three euro bonds in the total amount of EUR 2.3 billion.

Investment funds

Despite the events that dictated developments on foreign capital markets, investors did not make net withdraws from investment funds over the first nine months of the year. The net inflow into funds was positive in the amount of EUR 2.6 million. Over the same period of 2015 there was a net inflow of EUR 130 million, as a result of the release of funds from the privatisation process. The increased uncertainty brought a change in the breakdown of investments by fund type: equity funds and mixed funds recorded net withdrawals of EUR 70.5 million and EUR 4.6 million respectively over the first nine months of the year, while bond funds and money-market funds recorded net inflows of EUR 51.2 million and EUR 25.1 million respectively.

Figure 3.14: Year-on-year growth in mutual funds by type, in percentages (left), and net cash flows by investor sector, in EUR million (right)



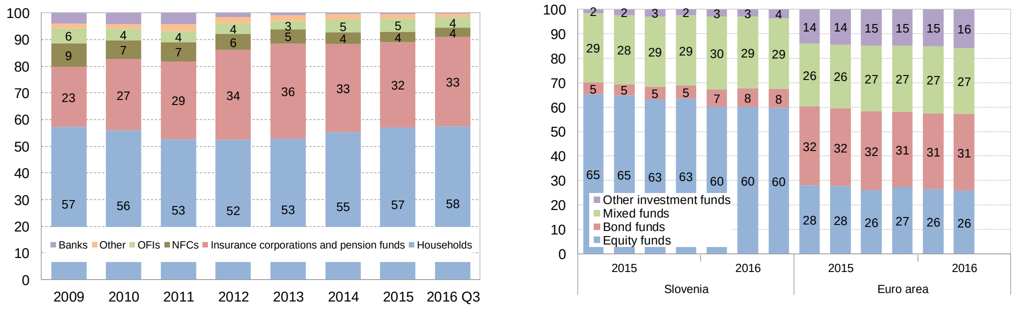
Source: Bank of Slovenia

Households invested significantly less in mutual funds compared with the previous year. Their net inflows amounted to just EUR 12 million, down EUR 80 million in year-on-year terms. There was a similar reduction in investment by insurance corporations and pension funds, whose net inflows of EUR 4 million were down EUR 28 million in year-on-year terms. Other financial corporations recorded net withdrawals of EUR 14 million from mutual funds, compared with net inflows of EUR 9.4 million in the same period of 2015. Non-financial corporations recorded net withdrawals of EUR 0.5 million, thereby continuing the trend of withdrawals seen in the previous year.

The ownership structure of domestic investment fund units remains stable, with a trend of increase in the proportions held by households and by insurance corporations and pension

funds. Households remain the largest owners of domestic investment fund units. The proportion that they hold increased by 0.5 percentage points over the first nine months of the year to 57.5%. Insurance corporations and pension funds also saw an increase in the proportion that they hold, by 1.4 percentage points to 33.4%. Non-financial corporations and other financial entities continued their gradual withdrawal from investment funds. Their total holding declined by 1.2 percentage points to 7.5%.

Figure 3.15: Ownership structure of domestic investment fund units by institutional sector (left), and comparison between Slovenia and euro area* of breakdown of investments by fund type (right), in percentages



Note: *Data for the euro area not available for the third quarter of 2016.
Sources: Bank of Slovenia, ECB

The breakdown of investments by fund type indicates that Slovenian investors retain greater appetite for higher-risk types of investment fund. Increased uncertainty on the market brought a year-on-year decline of 3.5 percentage points in the proportion of domestic investment funds' assets under management accounted for by equity funds in September 2016, to 59.7%. Slovenian investors' exposure to equity funds nevertheless remains above the average across the euro area, where the breakdown between bond funds, mixed funds and money-market funds is much more balanced.

4 MACROPRUDENTIAL POLICY INSTRUMENTS

There are currently six macroprudential instruments in effect in Slovenia. A measure to curb deposit rates, which currently is not acting as a limitation, was introduced in 2012, and a measure to restrict the pace of reduction in the LTD ratio (GLTDF) was introduced in 2014. The Bank of Slovenia developed two additional macroprudential instruments in accordance with the Banking Act (the ZBan-2) in 2015: the countercyclical capital buffer and the capital buffer for other systemically important institutions (O-SII buffer). The two buffers are currently at a level of 0%. September 2016 saw the entry into force of the macroprudential recommendation for housing loans, which introduces two macroprudential instruments. The Bank of Slovenia issued the macroprudential recommendation pursuant to the Macroprudential Supervision of the Financial System Act (the ZMbNFS).

Countercyclical capital buffer

The countercyclical capital buffer introduced pursuant to the ZBan-2 pursues the intermediate macroprudential policy objective of "mitigating and preventing excessive credit growth and excessive leverage". The purpose of the instrument is to protect the banking system against potential losses when excessive growth in lending is linked to an increase in risks in the system as a whole, which directly increases the resilience of the banking system. Furthermore the countercyclical capital buffer constraints the expansive phase of the credit cycle by reducing the supply of loans or increasing the cost of lending. At the reversal of the credit cycle the Bank of Slovenia would relax the buffer, thereby mitigating the risk of the supply of loans being limited by regulatory capital requirements.

The countercyclical capital buffer rate may range from 0% to 2.5% of risk-weighted assets, only exceptionally it might be set higher.

The basic criterion for determining the buffer rate is the gap between the credit-to-GDP ratio and its long-term trend, but in light of the specific attributes of the Slovenian economy other indicators, such as annual growth in real estate prices, annual growth in loans to the domestic private non-financial sector, the LTD ratio for the private non-banking sector, ROE and the ratio of credit to gross operating surplus, have to be considered as well.

The Bank of Slovenia reviews these indicators on a quarterly basis, and decides on any change in the buffer rate on this basis. The buffer rate has remained unchanged at 0% since its introduction in January 2016.

O-SII buffer

The buffer for other systemically important institutions (the O-SII buffer) introduced pursuant to the ZBan-2 aims to limit the systemic impact of misaligned incentives with a view to reducing moral hazard, which is also one of the intermediate macroprudential policy objectives set out by the Guidelines for the macroprudential policy of the Bank of Slovenia.

The collapse of systemically important institutions could endanger financial stability, and could lead to significantly larger adverse effects on the financial system and the entire economy than could the collapse of a systemically unimportant institution. This requires the special regulation of these institutions, the objective of which is for the expected loss in the event of the collapse of a systemically important institution to be the same as the expected loss in the event of the collapse of an institution that is not systemically important. To meet this objective, the more systemically important an institution is, the smaller the probability of the collapse of the institution should be (compared with a bank that is not systemically important). An additional capital requirement for a systemically important institution reduces the probability of its collapse.

In identifying O-SIIs the Bank of Slovenia followed the EBA Guidelines, having committed itself to their application under the Regulation on the application of the Guidelines on the criteria to determine the conditions of application of Article 131(3) of Directive 2013/36/EU (CRD) in relation to the assessment of other systemically important institutions (O-SIIs) (Official Gazette of the Republic of Slovenia, No. 66/15; hereinafter: the regulation on the application of the guidelines). Banks are evaluated with regard to the criteria of size, importance to the economy of the European Union or of Slovenia, cross-border activity, and the interconnectedness of the bank or group with the financial system. Eight banks were identified as O-SIIs by the Bank of Slovenia in 2015 on the basis of the aforementioned indicators. The ZBan-2 stipulates that at least once a year the Bank of Slovenia should verify the fulfilment of O-SII criteria and the appropriateness of O-SII buffer rates. The same eight banks were identified during verification in November 2016. One of the banks (UniCredit Banka Slovenija d.d.) was placed in a lower category, and its buffer was therefore reduced. For other banks the buffer remained unchanged.

Table 4.1: Criteria of systemic importance of banks

Category	Weight	Criterion	Weight
Size	**25%**	Total assets	25.00%
Importance (including substitutability / financial system infrastructure)	**25%**	Value of domestic payment transactions	8.33%
		Private-sector deposits from depositors in the EU	8.33%
		Private-sector loans to recipients in the EU	8.33%
Complexity / cross-border activity	**25%**	Value of OTC derivatives (notional)	8.33%
		Cross-jurisdictional liabilities	8.33%
		Cross-jurisdictional claims	8.33%
Interconnectedness	**25%**	Intra-financial system liabilities	8.33%
		Intra-financial system assets	8.33%
		Debt securities outstanding	8.33%

Source: Bank of Slovenia

The capital buffer rate ranges from 0.25% to 1.00% depending on the importance of an individual bank with regard to the aforementioned criteria.

Table 4.2: Scores in assessment of systemic importance and capital buffer rates

	SYSTEMIC IMPORTANCE INDICATOR	CAPITAL BUFFER RATE AS OF 1 JANUARY 2019 (as proportion of total risk exposure amount)
NLB d.d.	3,098	1.00%
SID banka d.d., Ljubljana	1,352	0.50%
Nova KBM d.d.	778	0.25%
UniCredit Banka Slovenija d.d.	757	0.25%
Abanka d.d.	698	0.25%
Sberbank d.d.	686	0.25%
SKB d.d.	539	0.25%
Banka Koper d.d.	448	0.25%

Source: Bank of Slovenia

Instruments for the residential real estate market

The two measures pursue the intermediate macroprudential policy objective of mitigating and preventing excessive credit growth and excessive leverage.[52] The type and scope of the instruments are defined so that they do not encroach significantly on the current lending activity and business policies of banks, as the situation on the Slovenian real estate market is stabilising and does not currently pose any direct risk to financial stability. Housing loans represent a segment of lending activity that could face relatively high exposure to systemic risks at the start of a new financial cycle. The instruments described below are thus required as a preventive measure.

The macroprudential recommendation includes the recommended maximum level of the LTV (loan-to-value) ratio and the recommended maximum level of the DSTI (debt service-to-income) ratio. The recommended maximum level of the LTV ratio is 80%, while the recommended maximum level of the DSTI ratio is 50% for borrowers with monthly income less than or equal to EUR 1,700, and 50% for that portion of income up to EUR 1,700 inclusive and 67% for that

[52] Objectives and examples of instruments were defined in the Guidelines for the macroprudential policy of the Bank of Slovenia approved by the Governing Board of the Bank of Slovenia at its meeting of 6 January 2015.

portion of income exceeding EUR 1,700 for borrowers whose monthly income is greater than EUR 1,700. Moreover, in the loan approval process (when assessing creditworthiness) it is recommended that banks apply, *mutatis mutandis*, the limitations on the attachment of a debtor's financial assets set out in the Enforcement and Securing of Claims Act and the Tax Procedure Act, i.e. earnings that are exempt from attachment and limitations on the attachment of a debtor's financial earnings.

The macroprudential measures have been introduced as a non-binding recommendation. The introduction of the measures will facilitate the systematic monitoring of changes in housing loans in terms of the LTV and DSTI ratios, while harmonising the monitoring of credit standards amongst banks with regard to the aforementioned ratios. In the event of increased risks to financial stability as a result of failure to comply with the recommendation, the Bank of Slovenia will introduce a binding macroprudential measure, while the parameters of the instruments will be tightened in the event of rising systemic risks despite compliance with the recommended maximum values.

The introduction of the macroprudential instruments does not encroach on the responsibilities of banks in the assessment and take-up of risks. Banks must continue to define their own internal policies in the assessment and take-up of risks with regard to the value of real estate collateral and the creditworthiness of borrowers.

The Bank of Slovenia will monitor compliance with the recommendation via annual surveys of the structure of new housing loans or via regular examination of banking operations. The first assessment of compliance with the recommendation will be conducted in 2017. In so doing the Bank of Slovenia will take into account the time required by individual banks to adapt their information and risk management systems.