BANKA SLOVENIJE

BANK OF SLOVENIA

EUROSYSTEM

Policy Strategy Paper for Slovenia, 2015

Prepared by Banka Slovenije

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1. Introduction

This 2015 update of the Policy Strategy Paper for Slovenia reviews economic developments and policy implementation since the issuance of the previous edition on 17 July 2014, and sketches out some of the important challenges that need to be addressed in the period ahead.

The 2014 edition of the Policy Strategy Paper laid out a possible approach to setting the Slovene economy back on track from the prolonged recession triggered by the onset of the financial crisis in 2008. The paper highlighted **the importance of having a clear and coherent national policy strategy** for promoting macroeconomic and financial stability, openness to equity investment, and addressing the institutional and regulatory bottlenecks that currently inhibit investment. Key policy priorities identified for establishing macroeconomic and financial stability included **restoring the health of the financial sector, restructuring the corporate sector, and reinforcing the sustainability of the public finances**. The paper also emphasized that policy choices needed to be crafted with a medium-term orientation and that they should be communicated clearly to the public to establish accountability and credibility. Successful policy implementation depended on political resolve, social consensus, and policy coordination. These considerations still remain important and cannot be ignored.

The state of the real economy and the financial sector in Slovenia has improved during 2014−2015. The economy is growing at a solid pace, with recovering domestic demand and decreased systemic risk for the banking sector. This reflects to a large extent the positive impact of policy initiatives taken by the government and Banka Slovenije in late 2013. However, conditions are not fully in place for strong sustainable growth. The financial sector is faced with new challenges associated with regulatory and institutional changes and the prevailing macroeconomic environment. Although fiscal consolidation efforts to comply with the requirements of the Stability and Growth Pact continue, risks to fiscal sustainability in the medium and long term remain high.

2. Real sector challenges

Notwithstanding its solid pace, real GDP growth is fragile as underscored by its composition, quality, and outlook. The recovery of domestic demand has been supported by a pick-up in private consumption and relatively high growth of public sector investment. However, private investment demand remains muted. Saving in the corporate sector exceeds investment, which explains the persistent large current account surplus. GDP growth is driven by increase in employment and not by higher productivity that is needed. **Net foreign demand remains a key anchor of Slovenia's growth process, but the international environment has become clouded with uncertainty in recent months**. Thus, there is a risk that demand conditions in Slovenia's main trading partners could be weaker-than-projected. Furthermore, economic growth in the near term is likely to be dampened by a drop in public investment owing to an initial period of foreseen lower drawings of European Union funds during the transition to the 2014−2020 financial perspective.

Stimulating private investment

Increased private investment is essential for sustained strong economic growth. Private investment remains low despite an accommodative monetary policy stance. The ECB's non-standard policy measures and quantitative easing have contributed to a decline in interest rates on corporate loans by 2 to 2½ percentage points since end 2013. **Nevertheless, investment remains weak because of the high corporate debt overhang.** Highly indebted companies are focused on deleveraging and the easing of monetary conditions will not necessarily induce them to borrow more for financing investment. At the same time, a high level of indebtedness impairs firms' credit worthiness and, thereby, their ability to borrow and invest. **Thus, priority has to be given to further restoring the balance sheets of both enterprises and banks.**

Investment is likely to pick up as enterprise restructuring unwinds and increases in demand for goods and services begin to have a favourable impact on business expectations. **However, the funding model should not be the same as that pursued during the pre-crisis period of unsustainable growth. It will be necessary to limit the reliance on debt financing and shift towards more equity financing.** For this to happen, Slovene enterprises will have to become more receptive to equity financing from both domestic and foreign sources **even though this implies changes in ownership structure**, and the business environment will have to be improved.

Investment recovery would be forthcoming at a faster pace if we had in place agreement on strategic priorities for economic development, supportive measures relating to risk sharing, and stimulus for capital investment aimed at actors with surplus savings.

Investment in Slovenia is deterred by institutional and regulatory bottlenecks that add to the costs of doing business and decrease expected future profits. The 2015 Annual Report of *Economic Freedom of the World* shows a drop in Slovenia's ranking based on performance indicators that focus on institutional capacity, public administration efficiency and burden of red tape for conducting business. Thus, as already emphasized in the 2014 Policy Strategy Paper for Slovenia, **steps should be taken to ease the regulatory and other barriers such as inadequate creditor rights as measured by laws and regulations, lengthy time period for enforcing contracts, government interference in enterprise management, a relatively inflexible labour market**, **as well as lengthy licensing and property registration procedures.**

Ownership restructuring and corporate governance

Sustaining growth will require not only capital deepening but also improvement in productivity. **This entails business restructuring, the adoption of new technologies and more efficient managerial techniques, which can be facilitated through privatization and entry of private investors**.

Privatization is crucial in an economy with a high share of State ownership. The government has defined the policy for state ownership and classified state assets into three categories. Companies classified as "strategic" and "important" will be partially privatized while those identified as "portfolio" will be fully privatized after they have been restructured. The Slovenian Sovereign Holding is responsible for managing the state-owned companies and restructuring of "portfolio" companies earmarked for full privatization. State ownership should be based on strategic consideration on investment, in research and development as well as in jobs.

So as to eliminate political interference in the operation of state-owned companies, the Supervisory and Management Boards of state-owned companies have to be staffed by professionals and given operational independence. Success of the state-owned companies will hinge critically on how the Board members are recruited and how well the Slovenian Sovereign Holding exercises its oversight responsibilities and promotes **greater economic efficiency.**

Financing small and medium-sized enterprises

Creating a supporting environment for small and medium-sized enterprises (SME) will do much for enhancing the growth potential of the economy. Improving SMEs' access to finance is crucial, in particular for those that are currently underserved by the market. It would be important to develop new financial instruments for start-ups and young fast-growing enterprises. Moreover, efforts should also be directed towards increasing the awareness of potential and existing entrepreneurs on access to finance, putting in place a one-stop shop structure to help SMEs overcome the administrative barriers for obtaining financial support, and providing support for getting foothold in export markets.

However, the banking sector alone cannot be expected to meet all the financing needs of SMEs. Lending to SMEs is inherently risky and evaluation of these risks is not easy. Elsewhere, venture capital investments fill the gap that banks cannot cover. The venture capital market in Slovenia is thin. **Thus, we need to explore methods for attracting higher volume of venture capital investment from foreign sources.** For established SMEs whose owners are wary of relinquishing some degree of control that is typically associated with equity funding, **mezzanine financing arrangements would be a useful option to pursue.**

3. Financial sector policies

Supply-side constraints to credit growth?

The continuingly weak credit activity is no longer the result of liquidity or capital shortage in the Slovene banking system. In fact, the low take up in the auctions of liquidity under the ECB's targeted longer-term refinancing operations (TLTRO) programme is a manifestation of the excess liquidity in the banking system, not only in Slovenia but the euro area as a whole. Monetary policy cannot take on the functions of other types of economic policy. If other economic policies were present, monetary policy could better stimulate economic growth.

A main cause of weak credit dynamics is the impairment of the monetary policy transmission channel resulting from the weak balance sheet of the corporate sector and consequently of the banking sector. **The volume of non-performing loans on the balance sheets of banks remains high,** notwithstanding the transfer of a significant amount of non-performing loans of several large state-owned banks to the Bank

Asset Management Company. **As long as asset quality is poor and expected default rates are high, speedy recovery in credit activity is not to be expected.**

Banks must be careful not to boost credit growth by ill-considered softening of credit standards. We must not repeat the mistakes of the pre-crisis period. Matters may become worse if additional credit availability enables enterprises to postpone balance sheet adjustment. The focus should be on the proper allocation of credit instead of its aggregate amount. It is important that good borrowers rather than the bad ones are the main beneficiaries of credit growth.

Moreover, banks should review their lending practices and tighten credit standards for certain clients. Recent research by Banka Slovenije staff suggests that credit risk has been building up and that to a certain measure credit misallocation has persisted even after the onset of the crisis.[1]

On the one side, enterprises with large bank debt overhang have been deleveraging. On the other side, the leverage of new entrants and continuing firms that have expanded operations has increased sharply since the onset of the crisis in 2008. The bank debt-to-asset ratio of the latter two groups in 2014 was nearly as high as the leverage ratio of the total enterprise sector just prior to the crisis. The debt service burden has so far been restrained and credit risk has not materialized because of the prevailing low interest rate environment.

Evidence suggests that a substantial proportion of the outstanding bank credit may not have been directed toward increasing the productive capacity of the economy. In 2014, about 70% of outstanding bank credit stock was allocated to financial investments and 11% of bank credit was accounted for by enterprises with negative value added.

Solving the non-performing loan problem

A speedy reduction of non-performing loans is crucial to supporting credit growth. Towards this end, Banka Slovenije, in cooperation with the Bank Association of Slovenia, is overseeing a programme for restructuring of non-performing claims. Systemic solutions supporting the development of a market in distressed assets would make resolution more efficient and faster.

[1] Ćirjaković, J., Banerjee, B., and Košak, T. (2015). Firm indebtedness, deleveraging and exit. Paper presented at the Conference on Challenges for Debt Restructuring and Financing of SMEs, Bank of Slovenia and European Comission. Ljubljana, 23 September 2015.

Initially the focus was on restructuring the non-performing claims on large enterprises. **Banka Slovenije amended the supervisory guidelines in 2014 so that banks could take a more active role in the corporate restructuring process**. It has also been proactive in facilitating the drawing up of Master Restructuring Agreements between banks and 60 large enterprises. During the past two years, about € 2 billion of non-performing claims on large enterprises have been restructured on the basis of these restructuring agreements. Banka Slovenije plans to undertake in the coming months an assessment of the quality of the restructuring of these non-performing claims.

Attention is now being directed towards the restructuring of non-performing claims of SMEs. The task is challenging, in view of the very large number of firms involved and their small size. In addition, because the financial statements of SMEs are often weak it is not easy to distinguish viable firms from non-viable firms. Banks have already prepared their loan restructuring targets and timetable for implementation, and these are currently being reviewed by Banka Slovenije. **Guidelines for restructuring, prepared jointly by Banka Slovenije and Bank Association of Slovenia, are expected to be ready by end-2015. In addition, Banka Slovenije has suggested drawing up procedures for establishing a special-purpose vehicle (SPV) for non-performing claims**.

A host of supporting reforms is needed to enhance the effectiveness of the efforts to reduce non-performing loans. Banka Slovenije is upgrading the Central Credit Register with the aim of improving the quantity and quality of debtor information. It would be important to make the bankruptcy process more efficient and collection of debts easier. This would decrease the cost of recovering assets provided as collateral for loans and facilitate the creation of a market for distressed assets. The use of informal out-of-court restructuring agreements has increased following the amendments to the insolvency framework in 2013**. However, the length of in-court restructuring proceedings remains substantial (ranging from 129 to 292 days) and the recovery rate is relatively low (averaging about 37%). We should remove the constraints to faster resolution of non-performing issues arising from existing tax treatment of loan-loss provisioning and loan write-offs.**

Banka Slovenije also is adopting a preventive approach to tackling the non-performing loans problem. To ensure that the risk of repeated build-up of loan losses is minimized, banks have been provided guidelines to develop early warning systems that will include indicators of future distress**. Banka Slovenije is participating in a high-level task force set up by the European Central Bank in September 2015, aiming to make the resolution of NPLs speedier. The objective is to develop and**

implement a supervisory approach that will encourage swift recognition of loan losses and their speedy resolution.

A new regulatory and supervisory framework

The recapitalization of banks by the government, the transfer of a significant amount of non-performing loans to the Bank Asset Management Company, and the on-going restructuring of non-performing claims on enterprises with Master Restructuring Agreements have helped stabilize the Slovene banking system. Profitability of the banking system as a whole has returned to positive territory in 2015 after five years of losses. Banks are adequately capitalized and have ample liquidity. Although credit risk and strategic risk remain elevated, aggregate systemic risk is estimated to have declined in 2015.

The supervisory culture throughout the euro area is being unified under the ECB's Single Supervisory Mechanism (SSM) that assumed responsibility in November 2014. For the credit institutions not directly supervised by the ECB, Banka Slovenije is aligning its supervisory approach with that of the SSM. Nevertheless it takes into account the need for paying adequate attention to the situation in the national economic environment.

Regulation and supervision is being strengthened to make the future of the banking system more stable and less crisis-prone. The financial crisis has demonstrated very clearly the importance of having adequate safeguards in place to prevent unhealthy risk taking and unsustainable credit growth. Hence, prudential rules of the Capital Requirements Directives (CRD) IV requires putting in place by specific dates new requirements on, among other things, quality and quantity of capital (in the form of several layers of capital buffers), liquidity, leverage, and counterparty risk. The requirements of the CRD IV have been incorporated in Slovenia's new Banking Act (ZBan-2).

The business outlook for banks

The requirements of the new regulatory framework will have an impact on the business models of banks. Besides coping with the higher costs on account of new regulations, the business models of banks have to adapt to the low-interest environment. The outlook is therefore one of low bank profitability. **Slovene banks are facing further pressure on their profitability in the near term because a large volume of debt securities in their portfolios were originally issued at a relatively high yield and these are set to mature. Apart from this, banks are exposed to the risk of a rise in interest rates since the gap between the average repricing periods of asset and liability interest rates has been widening.**

Banks should prepare contingency plans for responding to likely pressures on profitability. Engaging in high-risk lending in quest for higher profits should be avoided. On the contrary, in order to guard against credit risk, banks should check the interest sensitivity of their clients' business plans as an integral part of assessment of loan applications.

Banking sector consolidation

Sustainability of the business models of banks is crucial for the long-term stability of the banking system. **The current structure of the banking sector in Slovenia is not sustainable in the long term,** considering the size of the sector and the economy as a whole. The commonly-used measure of market concentration (the Herfindahl-Hirschman Index) has decreased in the Slovene banking system during the past decade. In 2014, the index stood at 1026, which is at the lower end of the range (1000 to 1800) that the ECB denotes as moderate concentration. This implies that there is significant scope for rationalization. Consolidation in the banking sector is already under way, with two banks in the final phase of winding down and two merger cases. **A reduced number of banks should contribute to economies of scale, thereby increasing efficiency and profitability.** This is confirmed by the finding of a recent study by Bank of Slovenia staff that concentration in the banking sector was positively associated with profitability during 1999−2014.[2]

Banka Slovenije created a national resolution fund in March 2015 to facilitate the consolidation of weak banks. The objective was to be ready to rescue distressed banks without additional burden to public finance even before the new European resolution mechanism took effect in 2016. An important task ahead is to work out the harmonization of the operations of the national resolution fund and the EU resolution fund. A functioning bank resolution regime will strengthen the incentives for bank to be more selective in their lending decisions and monitor borrowers closely. This will promote financial stability and long-term growth.

Establishing macroprudential oversight

The Bank of Slovenia has established, like other European central banks, an institutional framework for macroprudential oversight of the financial system that is in line with the recommendations of the ESRB. The basic aim of macroprudential oversight is to safeguard the stability of the financial system by

[2] Banerjee, B., Ahtik, M. and Schipper, J.E. (2015). The Determinants of Bank Profitability in Slovenia, 1999−2014. *Bančni vestnik*, 64, no. 11, pp. 21–32.

identifying the emergence of systemic risks at an early stage and taking preventive measures to mitigate these risks. The groundwork has already been carried out for the introduction of a counter-cyclical buffer and a capital buffer for systemically important institutions. **In the coming months, the Bank of Slovenia will focus on analyzing the pre-requisites for the introduction of real estate related instruments and a systemic risk buffer.**

4. Fiscal policy

It is important to continue with the fiscal consolidation to ensure fiscal sustainability in the long term. As a member of the European Union, Slovenia is obliged to implement its obligations under the Stability and Growth Pact (SGP). Slovenia was placed in the Excessive Deficit Procedure (EDP) of the SGP in December 2009, and is required to correct the excessive fiscal deficit by 2015. After the correction of the excessive deficit, Slovenia will have to the fulfill requirements of the preventive arm of the SGP as well as the transitional arrangements that requires making sufficient progress towards bringing down the public debt to below the 60 percent of GDP reference value. The task of fiscal consolidation to comply with the SGP requirements is all the more challenging, especially in the long term, on account of the need to accommodate increased expenditure pressures from pensions and health care, and the risk posed by sizeable government guarantees.

The headline general government deficit in 2015 is expected to fall to 2.9% of GDP, which will allow Slovenia to exit from the EDP. The draft 2016 budget projects a further decline in the deficit to 2.2% of GDP predicated on a mix of revenue enhancing and expenditure saving measures. On the revenue side, the temporary increase in VAT introduced in 2013 is being made permanent and additional measures are being adopted to improve tax compliance, including the introduction of compulsory cash registers. On the expenditure side, saving will be reaped from the extension of several temporary measures on containing the public sector wage bill, social transfers and pensions and from lower capital expenditure.

In the opinion of the European Commission, the draft 2016 budget is “broadly compliant with the provisions of the Stability and Growth Pact”. However, Commission has pointed out that the improvement in the structural balance underlying the draft 2016 budget (0.4 percentage point of GDP) falls short of the 0.6 percentage point of GDP improvement that is required under the preventive arm of the SGP. There is a risk, mainly emanating from the expenditure side, of the deviation turning out to be larger than currently estimated. The estimated saving in the wage bill hinge critically on the ongoing negotiations with the trade unions, and there are uncertainties relating to the costs on refugee and migrant relief and rehabilitation, loan work-out activities of the BAMC, and certain government guarantees being called in.

Looking beyond to 2017−2019, Slovenia's 2015 Stability Programme report foresees an annual improvement in the structural fiscal balance (0.3 percentage point of GDP) that is smaller than amount specified in the preventive arm of the GDP (0.6 percentage point of GDP). Prolonged non-compliance with the requirements under the preventive arm of the SGP would send a negative signal to investors with a consequent risk of rising bond yields. Hence, it would be important to identify additional durable measures at an early date and prepare the groundwork for timely and consistent implementation.

A number of important structural reform projects have been initiated but progress has been patchy. The Fiscal Rule Act was approved by Parliament in July 2015, but the appointment of the Fiscal Council that will oversee the implementation of the law has run into unexpected delay. The preparation of the White Paper on policy options for further pension reform to ensure the long-term sustainability of the pension system also has been delayed. On the positive side, a comprehensive review of health care expenditure has been completed, and the government expects to adopt a national health care plan for the period 2015−2025 by end-2015. Enabling legislation for health care reform, prepared on the basis of these two documents, is expected to be in place in the second half of 2016. **Besides ensuring fiscal sustainability in the long run, the dividends from resolute and immediate implementation of structural fiscal measures will help create the space for fiscal policy to support monetary policy efforts in stimulating demand and growth.**

Increased and better absorption of EU funds from the 2014−2020 financial perspective is a priority. The drop in the drawdown of EU funds in 2016 during the transition to the new financial perspective will be a drag on economic growth. Policy makers should aim for a more stable profile of EU funds drawdown and direct resources to growth and technological development-enhancing investment. The new regulations on public procurement and the creation of a public portal providing information and advisory services to potential users of EU funds in one place will facilitate faster absorption of EU funds. However, the monitoring of EU-financed projects, administrative support to applicants and verification of payment claims should be stepped-up to avoid interruptions in funding.

The drawing up of a national developmental strategy should aim at tighter integration of municipalities or the establishment of regions, as individual municipal budgets often fall short of EU requirements for tenders. The strategy should also define criteria for priority investments and their financing.

5. Conclusions

Economic growth has resumed in Slovenia, but bank credit dynamics remain weak despite an accommodative monetary policy stance and ample bank liquidity. A main cause is the impairment of the monetary policy transmission channel on account of a high corporate debt overhang and a large volume of non-performing loans on the balance sheets of banks.

Further easing of monetary policy stance is not the magic wand for unlocking credit growth. Further repairing the balance sheets of the corporate and consequently also of the banking sector is key. Banka Slovenije is actively engaged in this endeavor. Boosting credit growth by lowering credit standards carries the risk of repeatedly inflating unsustainable credit. The funding model should not be the same as that pursued before the crisis boom period. It will be necessary to limit the reliance on debt financing and shift towards more equity financing. Improvements in the business environment are essential for attracting new non-debt capital flows. The role of the State in economy should be redefined and reduced because, amongst other reasons, of the systemic treatment of State aid in the European environment.

The stability of the banking system has been enhanced through recapitalization and partial resolution of non-performing loans. A new regulatory and supervisory framework is being introduced to make the future of the banking system more stable and less crisis-prone. The higher costs on account of new regulations and the prevailing low-interest environment imply a low profitability outlook for banks. In this environment, there is significant scope to benefit from rationalization and consolidation. A reduced number of banks as well as trimmed business models should contribute to economies of scale, thereby increasing efficiency and profitability.

Slovenia appears set to exit from the Excess Deficit Procedure in 2015. However, Slovenia is required to undertake substantial fiscal consolidation in the near term and over the medium term under the preventive arm of the Stability Growth Pact. Durable measures, including much-needed structural reforms, are required to achieve the fiscal consolidation process. Increased utilization of EU funds and creation of additional fiscal space within the limits of European fiscal rules would provide much needed support to monetary policy for securing strong sustainable growth.