Policy Strategy Paper for Slovenia

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Prepared by Banka Slovenije

1. Introduction

Slovenia has experienced a full cycle of economic expansion and contraction during the past decade. Rapid economic growth followed European Union accession in 2004, fed by excessive borrowing and risk taking by banks and enterprises that was facilitated by access to external funding. **This framework was not sustainable and excessive borrowing heighted the vulnerability of the economy**. The global financial crisis hit Slovenia particularly hard. The onset of the financial crisis in 2008 caused a sudden stop in external financing. **Slovenia was caught in a cycle** of reduced credit availability, deleveraging, a cutback in corporate investment and output, and rising non-performing loans. The recession that followed was one of the most severe in the euro area, with the second largest cumulative drop in GDP after Greece. In the process, public finances came under severe strain and, **as early as in 2009, Slovenia was placed under the Excessive Deficit Procedure of the European Commission requiring substantial fiscal consolidation efforts in the near term and medium term.**

While there are indications that an economic recovery is underway, growth is likely to remain weak and fragile until the impediments to growth that have resulted from the crisis are properly addressed. **For Slovenia, there is no other way.**

It will not be possible to achieve durable economic growth based on the same model as that pursued during the pre-crisis boom period. The structural weaknesses of the economy that were masked during the boom years and became amply evident during the recession must be eliminated. **The comprehensiveness of the policy package, the complementarity of measures and their speed of implementation will determine how quickly durable economic growth is restored; and the economic growth must be based on equity-financed investment and not on debt-financed investment.**

This paper sketches out some of the important areas for further policy action. **It is not meant to be an exhaustive compendium of strategy policy recommendations.** Rather, it should be seen as providing an approach to setting the economy back on a sustainable track. Alternative policy

approaches are certainly possible, but then these should be quantified and costed properly in order to determine their feasibility and suitability to address the prevailing conditions.

The policy priorities for putting the economy on a solid sustainable growth path are:

(i) the efficiency of the legislation and judiciary system;

(ii) deleveraging and restructuring of enterprises;

(iii) restoring the banks' balance sheets and establishing more sustainable foundations for financial stability;

(iv) reinforcing the long-term sustainability of public finances

With regard to the growth paradigm, the crisis has demonstrated very clearly the importance of limiting the reliance on debt-financing and having adequate safeguards in place to prevent credit bubbles. Also, it is clear that recourse to more state funding for restructuring the economy and increasing investment essential for growth is not a feasible option. A shift towards more equity financing is therefore urgently necessary, for which, an appropriate environment has to be in place for attracting new non-debt capital flows.

The main requirements in this regard are 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.

Some of the required policy measures have been implemented already, and their positive impact is becoming visible. However, if a determined follow through with enterprise restructuring and fiscal consolidation is not forthcoming, **the nascent recovery is likely to be derailed**. The recent recapitalization of banks and the excess financing of government borrowing requirement have created a limited time window for implementing the additional supporting measures. If policy measures are not implemented, the capital buffer of banks created by bank recapitalization will erode over time and economic problems will intensify.

The policy choices need to be crafted with a medium-term orientation and they should be communicated clearly to the public **to establish accountability and credibility**. Successful

implementation will require political resolve and social consensus. Because of the complementarity of measures, policy coordination between governmental agencies and other stakeholders is essential in implementing the measures. Everyone involved in policy implementation has to accept responsibility and accountability for the tasks assumed.

2. Financial sector policies

The crisis brought about a severe deterioration of the balance sheets of banks and a disruption of the credit transmission channel. The boom years before the crisis were marked by excessive bank borrowing in foreign financial markets, thus bringing debt capital to Slovenia. During the crisis, banks have been forced to reduce quickly their indebtedness levels as a result of the reduced trust of the financial markets. Access to Eurosystem refinancing and the increase in domestic deposits have made up for only a small part of the funding shortfall. At the same time, with the negative growth, non-performing loans to total loans increased more than four-fold since the beginning of the crisis and amounted to as much as one fifth of the banks' total assets in September 2013. As a result of too slow bank capital enhancement efforts and a limited access to finance and a rapid deterioration of corporate balance sheets, net bank lending to the private sector slowed sharply during 2009−2010 and became negative during 2011−2013.

Banka Slovenije, in cooperation with the Government, has embarked on restructuring the banking sector with the objective of creating well-capitalized and profitable banks that perform financial intermediation efficiently, practice good governance and do not indulge in credit exuberance seen during the boom years.

The rehabilitation strategy involves the following elements:

(i) repairing the balance sheets of banks through recapitalization and transferring non-performing loans to the Bank Asset Management Company (BAMC);

(ii) bank resolution through liquidation and consolidation;

(iii) divesting state shareholdings in banks;

(iv) strengthening banking supervision and risk management; and

(v) establishing macroprudential oversight.

Improving banking system stability

Based on the findings of a comprehensive asset quality review and stress tests, five banks were recapitalized in December 2013 in an amount totaling € 3.2 billion (10.3% of GDP), while five banks were asked by the Bank of Slovenia to increase their capital from private sources within specified time periods in 2014. Three of these banks have provided for the capital increases from private sources, one bank, however, was not successful in this regard and is now in the process of having the state aid approved, while one bank has the possibility to find private funding sources by the end of 2014. If this possibility does not materialize, the commitment by the state to implement the state aid measures will be realized.

In parallel with bank recapitalization, non-performing loans of the three large state-owned banks (NLB, NKBM and Abanka) in an amount of € 4.6 billion were identified for transfer to the BAMC. Approximately two-thirds of these assets were transferred in December 2013. The remaining one-third (Abanka) and Banka Celje's assets - this bank entered the state aid procedures in April - will be transferred in the course of 2014. The exact timing of the transfer will depend on the approval procedures of the European Commission. However, it is worrisome that non-performing loans remain high even after the transfers to the BAMC and their volume has even increased in Q1, 2014. This is **a result of the still weak economic growth, slow deleveraging in the corporate sector and too slow enterprise restructuring**. By transferring additional impaired assets from the remaining part of the banking sector to the BAMC, the BAMC will have at its disposal a sufficient portion of claims for taking the lead role in faster enterprise restructuring, enabled under the new insolvency legislation. Additionally, based on the recent amendments to the supervisory regulations of the Bank of Slovenia, banks will have to take a more active role in the corporate restructuring process.

Bank resolution through liquidation, consolidation and privatization

The current state and the structure of the banking sector is not sustainable in the long term, considering the size of the sector and the economy as a whole. A reduced number of banks will contribute to economies of scale, thereby increasing efficiency and profitability. Two small domestic banks are currently in the process of being wound down, the restructuring process must

urgently be continued by integration of banks. At the moment, however, their further consolidation may only be **proposed by the state as the majority owner of banks**.

Good governance should also lead to higher efficiency in the banking sector. Toward this end, on 21 June 2013, the National Assembly adopted its commitment to fully divest its shareholdings in one state-owned banks (NKBM) and reduce its participation in the largest bank (NLB) over the medium term to 25% plus one share. Slovenian Sovereign Holding (SSH), on behalf of the Government, has already launched a call for a non-binding statement of interest for the full stake in NKBM. Preparations for the privatization of other banks, that are recipients of the state aid, and the transfer of the second package of non-performing claims to the BAMC will begin once their restructuring programmes are approved by the European Commission. The successful completion of bank privatization depends on the follow-through by the **Government on its commitments as well as on market interest in Slovenian banks**.

Strengthening bank supervision and risk management

Effort to further strengthen bank supervision is under way. Regulation (EU) No 575/2013 (CRR) entered into force on 1 January 2014, and Banka Slovenija is in the process of drafting a new Banking Act with the aim of incorporating the requirements of the Directive 2013/36/EU (CRD IV Directive), introducing capital shock absorbers, enhancing risk management and governance standards, and increasing transparency and statistical disclosure. The new legislation is expected to be in place by end-2014.

At the same time, Banka Slovenije is actively preparing for the implementation of the Single **Supervisory Mechanism from November 2014** which, among other things, will bring unified supervisory methodologies and standards at the Eurosystem level.

Banka Slovenije is aligning its supervisory approach to the regulatory changes and will make certain that subsequent EBA technical standards and supervisory practices arising from its guidelines are duly implemented by banks. Banka Slovenije is already active in checking that legally questionable business practices are eliminated from banks. A **Special Inspection Group** for cooperation with other competent government authorities has been established to detect and analyse possible criminal abuses in the banks. Strengthening banks' risk management rules and ensuring compliance with the supervisory measures are a priority. Unhealthy risk-taking business

practices and corporate governance practices that endanger interests of the banks as well as the behaviour of members of Management bodies that could have negative impact on their reputation and the results of the bank (fit & proper criteria) will be duly assessed and addressed by Banka Slovenije.

An important supervisory tool that will soon become available to Banka Slovenije is a **Central Credit Registry** (CCR). As the current system of registering credits is limited in its scope, Banka Slovenije deems it important to upgrade the CCR as soon as possible to support supervisory tasks.

Bank resolution mechanisms with a wide set of resolution powers have to be established by the beginning of 2015. These measures pursue the requirements of the Directive 2014/59/EU establishing a framework for the recovery ad resolution of credit institutions and investment firms. The ultimate goal is that the resolution function in Slovenia will be independent but at the same time intertwined with the Banka Slovenije's banking supervision function.

To achieve the desired goals, **Banka Slovenije has recently undertaken a wide internal reorganization** that should yield higher efficiency and quality of all its tasks and functions. As the resources in the supervisory area are inadequate, Banka Slovenije is paying more attention to this area in different ways.

Establishing macroprudential oversight

The crisis has demonstrated the need to add a **macroprudential perspective** to the supervision of financial system. Thus, in line with recommendations ESRB/2011/3 on the macro-prudential mandate of national authorities, also accepted by other European central banks, the institutional framework for macroprudential oversight of the financial system was established by Banka Slovenije in 2014. The basic aim of the **Financial Stability Committee** is setting recommendations to safeguard the stability of the financial system by identifying the emergence of systemic risks at an early stage and taking preventive measures to mitigate these risks.

Banka Slovenije adopted two macroprudential instruments in 2013 and 2014. The first instrument places a cap on deposit interest rates and imposes a capital add-on requirement for exceeding this cap. The measure has contributed to a reduction in passive interest rates. The

second instrument aims at slowing down the pressure on too fast deleveraging in the banking sector, stabilizing the banking system funding structure and thus providing conditions for a faster credit growth recovery.

3. Corporate restructuring

Until the financial and ownership structures of enterprises and business operations of the corporate sector are restructured, credit growth in banks is hard to be expected, and banks will remain fragile. If non-performing loans continue to increase in Q1 2014, delays in corporate restructuring will gradually **erode the bank capital cushion created by bank recapitalization**.

The enabling legislative framework for enterprise restructuring is in place. The recent amendments to the insolvency legislation provide for preventive restructuring of viable companies in the pre-insolvency stage, for special compulsory settlement procedure for medium and large companies and for improvements of simplified compulsory settlement proceeding for small and micro enterprises. The aim is to mitigate the negative impact on activity by restructuring viable enterprises and liquidating unviable ones. **The efficiency of insolvency proceedings remains the key.**

However, systematic corporate restructuring is yet to begin and should be given **priority by the new government**. The task is challenging on account of two main factors. First, there are numerous complex, inter-connected group loans with several bilateral contracts and conflicting interests. Second, the BAMC is unable to take the lead in many important restructuring cases as the claims transferred to them are not sufficiently big to put them in a majority position vis-à-vis other creditors. Thus, as noted in the National Reform Programme document, a centralized and comprehensive approach towards the various credit exposures in the banking system is needed to accelerate the workout process and facilitate restructuring negotiations. Toward this end, a working group comprising of representatives of all stakeholders, relevant government authorities, with the cooperation of Banka Slovenije should be formed without further delay and vested with the responsibility of overseeing the entire restructuring process. **A decision must be made with regard to the most urgent restructuring cases**.

Ownership restructuring and new investments

A critical constraint that Slovenia faces is **the availability of funding for corporate restructuring and increasing investment activities**. The feasibility of using state resources for these purposes is limited because further increases in the size of the already large public debt would threaten debt sustainability. The fact is, there is no other capital in Slovenia but **the tax-payers' money**. As a result, privatization and entry of private investors should be the key vehicles for the required **non-debt capital infusion**. This strategy will have the added benefit of stronger corporate governance.

The new privatization law has been designed with this goal in mind. To provide a catalytic effect, 15 state-owned enterprises have been approved by Parliament for privatization during 2014−2015. The sale of three companies has been completed thus far.

For Slovenia to attract a significant volume of foreign direct investment, the business environment will have to be improved. The business and political culture will need to adapt and embrace the realities of globalization and Slovenia's integration in the world economy. **A communication strategy must be developed and implemented to promote and market Slovenia as an attractive FDI destination.** In parallel, steps should be taken to ease the regulatory and other barriers such as lengthy and costly licensing and property registration procedures (e.g., processing of building permits takes 182 days and property registration takes about 110 days on average) , inadequate creditor rights as measured by laws and regulations (the legal rights index for Slovenia is well below that for Austria and Slovakia), lengthy time period for enforcing contracts (1270 days), government interference in enterprise management, and a relatively inflexible labour market.

Since it is **not feasible to privatize a large chunk of the economy in a compressed time span**, for an interim period, the goal of **having state-owned firms managed by professional managers** pursuing good business and corporate governance practices is important. The new Government needs to quickly obtain parliamentary endorsement of the strategy for selection and classification of assets that will be managed by the Slovenian Sovereign Holding (SSH) company. **It is important how the Slovenian Sovereign Holding will be run and managed**.

4. Financing small and medium-size enterprises

Financing programmes offered by the Slovenian Enterprise Fund and Slovene Export and Development (SID) Bank have helped to support access to finance of small and medium-size enterprises (SME) during the challenging conditions in credit markets. Data indicates that SME loans in Slovenia increased every year during 2007-2011 except in 2009. The SME Access to Finance (SMAF) index for Slovenia prepared by the European Commission also shows an improvement during 2007-2012. Slovenia ranked in the middle among the EU-27 countries with regard to both the improvement in the SMAF index and its level. However, micro-level data suggest that SMEs have been negatively affected by the general tightening of credit conditions. Leaving aside the issue of access to finance, the financing costs and the collateral requirements have increased to a greater extent for SMEs than for large firms.

The funding programmes offered by the Slovene Enterprise Fund and SID Bank draw on resources made available by the European Investment Fund (EIF), European Investment Bank (EIB), and the European Mutual Guarantee Association (AECM). Looking ahead, it would be necessary **to increase the absorption of foreign resources** for supporting SMEs and to reduce the dispersion of institutions managing these resources. The EIF is replacing its current Competitiveness and Innovation Program by two new programmes with a larger pool of resources for the period 2014-2020 that will be seeking to target the more vulnerable categories of small businesses that are currently under-served by the market. The new programmes will only provide a framework, allowing financial intermediaries to create individual products that best suit the need of SMEs in their particular market. Thus, the two Slovene financial institutions, in coordination with their partner banks responsible for final credit delivery, should **develop new financial instruments for start-ups and young fast-growing enterprises** and, especially, explore methods for attracting higher volume of venture capital investments from foreign sources. In addition, it would be important to increase the awareness of entrepreneurs on access to finance, put in place a **one-stop** structure to help SMEs overcome the administrative barriers for obtaining financial support, and provide support for getting a foothold in export markets.

5. Fiscal policy

It is urgent to continue with the fiscal consolidation to ensure fiscal sustainability in the long-term. As a member of the European Monetary Union, Slovenia is obliged to implement the Stability and Growth Programme. Fiscal developments in Slovenia are subject to close monitoring by the European Commission and Slovenia is required to implement substantial fiscal consolidation in line with commitments adopted within the scope of European rules and Commission's directives. The protracted recession and the cost of bank recapitalization have put the public finances under enormous strain and the public debt burden has increased sharply. Slovenia was placed in **the Excessive Deficit Procedure** (EDP) of the Stability and Growth Pact (SGP) **in December 2009**, and is required to correct the excessive fiscal deficit by 2015. Even after the correction of the excessive deficit, Slovenia will remain subject to the transitional arrangements under the preventive arm of the SGP 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 on account of the need to accommodate increased expenditure pressures from pensions and health care, and the risk posed by sizeable government guarantees.

The main goals of the fiscal policy and the means to achieve these objectives should be well specified and communicated in a transparent manner. Possibilities of fiscal consolidation should be examined and its effects to the economy and public finance quantified within the room for maneuver given by the individual elements influencing budget items (health care, private higher-education institutions and their financing, regionalization, the number of municipalities, and similar) and in regard to their impacts to the economy and public finance. **For reasons of credibility, the macroeconomic assumptions** underlying the consolidation strategy and the estimated impact of the measures ought to be **realistic**. The risks and vulnerabilities that could affect the fiscal outturn should be highlighted. **The measures must be durable.** Stop-gap temporary measures to bring down the headline deficit are not sufficient, given that fiscal consolidation is also assessed under the SGP in terms of the improvement in the structural balance. The consolidation effort should include measures that enhance growth prospects, as this in turn will facilitate deficit reduction. Finally, the consolidation strategy should be careful to protect the most vulnerable sections of the population. This in turn increases **the complexity of**

the real sector restructuring, involving simultaneous business, financial and ownership restructuring.

The required size of fiscal consolidation

The assessment of the European Commission is that the fiscal effort during 2013−2014 "falls short by 1.4% of GDP in terms of change in the (corrected) structural balance and by 0.5% of GDP in terms of the amount of required measures estimated as necessary at the time of the Excessive Deficit Procedure recommendation".

In order to exit the EDP procedure in 2015, Slovenia will need to bring down the headline general government deficit to below 3 percent of GDP and meet the target for cumulative improvement in the (corrected) structural balance as well. To ensure full compliance with the EDP recommendation, implementation of additional permanent fiscal measures equivalent to 1.8% of GDP is necessary in the remainder of 2014 and in 2015 on a cumulative basis.

Looking beyond to 2016−2018, a larger improvement in the (corrected) structural balance than that projected in Slovenia's 2014 Stability Programme report is required. The preventive arm of the SGP stipulates that the improvement in the structural balance should be at least 0.6 percentage point of GDP annually when the output gap narrows to below −1.5% of GDP, which is expected to happen in Slovenia's case as from 2016. Whereas, the 2014 Stability Programme report visualizes an improvement of 0.5 percentage point of GDP in 2016, 0.3 percentage point in 2017 and 0.6 percentage point in 2018.

The measures to comply with the requirements of the corrective and preventive arms of the SGP should encompass both **revenue side and expenditure side measures.** The identification and implementation of the additional measures should begin as soon as possible in 2014 and not be delayed until 2015. Measures from the 2014 Stability Programme Update serve as a good starting point; and, in order to achieve fiscal goals, they must be first implemented and then upgraded with additional structural measures.

The **revenue-side measures** that may be considered should dedicate attention to the following areas:.

(a) Introducing a new property tax,

(b) Further strengthening tax collection enforcement efforts;

(c) Broadening the corporate income tax base;

(d) Curtailing the list of items subject to value added tax (VAT) at the lower rate.

On **the expenditure side**, measures to curb spending growth since 2012 have mainly involved (i) lowering the public sector wage bill through temporary cuts in basic salaries and holiday allowance, cancellation of wage indexation, a freeze on promotions and performance-related bonus, and a reduction in the number of employees; (ii) across-the board cuts in discretionary expenditures that were not supported by specific reforms; (iii) cancellation of indexation of pensions; and (iv) limiting expenditure on investment. The 2014 Stability Programme foresees the continuation of these policies in 2015. But, their implementation is dependent on certain actions being taken in a timely manner.

Also, these measures will need to be supplemented by **additional measures** to satisfy the required fiscal consolidation effort:

1. **health care reform;**
2. **pension reform;**
3. **labour market reform;**
4. **reorganization of local governments and their financing;**
5. **rationalization of expenditure on education**
6. **more efficient utilization of social transfers and subsidies.**

Since fiscal consolidation measures will limit financing of government investment from own resources, **increased and better absorption of EU funds is a priority**. It is vital to enhance administrative capacity in the managing of EU funds. Information and advisory services should be made available to potential users of EU funds **in one place**, in regard to investment possibilities, the preparation of project documentation and on dealing with the administrative procedures. Steps should be taken to streamline public procurement and permit procedures and make their implementation more transparent, thus, by way of recasting the legislation, preventing abuses and illegal proceeds obtained from public calls to tender. The monitoring of EU-financed

projects and verifications of payment claims should be stepped up to avoid interruptions in funding.

6. Concluding remarks

The deep prolonged recession since the onset of the financial crisis is a manifestation of unsustainable accumulation of financial imbalances founded on excessive borrowing in the pre-crisis period. Putting the economy back on track will require a coherent, integrated national policy strategy to restore the health of the financial sector, restructure the corporate sector, and reinforce the sustainability of the public finances. The economic recovery must be based on equity-financed investment and not on debt-financed investment. **Only in this manner can the effects of urgent saving be mitigated**.

The stability of the banking system has been enhanced by utilizing state funds, the ground has been prepared for strengthening bank supervision, risk management and governance standards. However, unless enterprise restructuring is undertaken decisively in a timely fashion, the capital **buffer of banks created by their recent recapitalization will erode and further capital injections will be needed once again**.

Slovenia faces a challenging task of attracting new non-debt capital from private sources for funding corporate restructuring and increasing investment. The appropriate business environment has to be created to achieve this goal. A communication strategy must be developed and implemented to promote and market Slovenia as an attractive FDI destination. **Further recourse to state funds is not a feasible option any longer**. Slovenia is required to undertake substantial fiscal consolidation in the near term and over the medium term under the corrective arm and preventive arm of the Stability and Growth Programme. A combination of difficult revenue-side and expenditure-side measures will be required to achieve the fiscal consolidation targets. **If a determined follow through on these fronts is not forthcoming the recovery will come to an end and economic problems will intensify**.

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