FINANCIAL REGULATION IN SLOVENIA

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Abstract

The paper consists of five parts. The country is presented first; this provides insight into the rationale of national financial regulation which was an important part of initial legal provisions of a new country. Financial regulation before the crisis had two distinct periods. Regulation in the period 1991-1998 can be referred to as authentic Slovenian financial regulation. It was followed by gradual adaptations of Slovenian regulation to EU and EMU financial regulation. The insight into the period of the crisis and often chaotic regulatory reactions of Slovenian authorities to it is followed by presenting a rather drastic reform of Slovenian banking in 2013 and 2014.
1. Introduction

1.1. The Creation and Development of the Country

The proclamation of the country’s independence on June 26, 1991 coincided with unresolved disputes over custom duties. Yugoslav federal authorities intervened by an attempt to grab the control of the borders. The army was, however, badly surprised by the resistance. After a week of fighting between the Yugoslav army on one side and Slovenian territorial defense and police on the other, Brioni ceasefire was attained. In accordance with it, Slovenia had to defer the implementation of independence activity for three months. On October 8, 1991, moratorium expired and Slovenia introduced its own currency - the Slovenian Tolar (SIT); the country became “fully independent”. This ended tense and uncertain political and economic developments in the eighties and, definitely so, in 1990\(^1\) when the political future of Slovenia was not yet firmly established and the shape of future arrangement within Yugoslavia was unknown. Consequently, the new Slovenian government, installed after elections in April 1990, began cautious preparation for a likely collapse of Yugoslavia by gradually acquiring control over economic policy and economic system. What remained unknown was the level of the disintegration, the way in which Yugoslavia would disintegrate, and when this would happen\(^2\). Indeed, separation from Yugoslavia was a kind of an “emergency exit”.

Slovenia has been often considered “a success story” of transition; early economic performances were satisfactory and social costs of transition were rather low. The reasons for that can be looked for in two major directions: initial conditions and patterns of transition. First, many essentials of a market economy were created before 1989; enterprises were autonomous, basic market institutions existed, and government could use many standard economic policy tools. Second, Slovenia, the richest of former socialist CEE countries could afford to implement macroeconomic stabilization cautiously with pragmatism and risk aversion while refusing patronage of international financial institutions and foreign advisers.

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\(^1\) For a comprehensive review of political, social, and economic development of Slovenia see »Slovenia – From Yugoslavia to the European Union«, The World Bank, 2004.

\(^2\) The predominant part of systemic framework for an efficient market economy was created in 1990 and 1991, i.e. before political independence. Simple, transparent, and non-discretionary system of direct taxes was introduced by Income Tax Act and Profit Tax Act. The statutes regulating monetary and financial system such as Bank of Slovenia Act, Banks and Savings Banks Act, Foreign Exchange Transactions Act, Rehabilitation of the Banks and Savings Institutions Act were also prepared in advance and passed together with the Declaration of Independence in June 1991. After independence, missing legal rules which guide economic conduct (company law), assure a predictable bargaining framework (codes regulating business transactions), enforce rules, and resolve disputes (bankruptcy, competition) were added.
Four periods can be distinguished in a brief economic history of the country: a short period of transitional depression (1991-1992), a decade of balanced economic and social development (1993-2004), the “gambling” period (2005-2008), and the crisis period (2009 - ). In 1993, Slovenia reached the bottom of transitional depression. After two years, the benefits of secession appeared to prevail over its costs. While the costs of reorienting trade from protected to competitive markets were significant, the secession intensified economic restructuring, pushed for sound economic policy, and enabled creation of a “normal” economic system. GDP grew at more or less constant rate of 4 percent annually, inflation was gradually lowered, state budget was nearly balanced, public debt amounted to 30 percent of GDP only, surplus in trade of services outweighed the deficit in trade of goods, and foreign exchange reserves more than matched foreign debt. Social cohesion was retained.

Monetary policy was crucial for preserving the Tolar and enhancing its role in a small currency area dominated by German mark as a measure of value, means of savings, and even transaction instrument. Foreign exchange transactions became the channel of money creation; the regulation of money supply and banks' liquidity shifted to open market operations and prudential regulation. After cautiously removing initial administrative restrictions on foreign exchange flows, monetary policy intervened sensibly to prevent substantial real appreciations of the Tolar which would result from excess supply of foreign exchange. Thus, monetary policy became trapped in conflicting goals: to lower and keep inflation under control or to prevent real appreciation of the Tolar. Bank of Slovenia (BS) opted for prevention of excessive real appreciation as the major goal, leaving disinflation to be handled by increased competition.

“Back to Europe” was a slogan of the last decade of the 19th century and the ultimate goal of all former socialist countries in Central and Eastern Europe, Slovenia included. A new “emergency exit” appeared with a delay but continued rather smoothly. In 1999, the country began preparations for joining EU and EMU which required changes in economic policies, particularly the opening of the capital market. When entering EU in 2004, Slovenia already fulfilled four Maastricht criteria and immediately assumed ERM2 status. In February 2005, the national master plan for the introduction of the euro was formally adopted. Contrary to hasty and uncertain procedures in conversion from Dinar to Tolar in 1991, the procedures in the conversion from Tolar to Euro were precisely scheduled (Jašovič, 2010). The changeover on January 1, 2007 was smooth (Rant, 2010). However, in the process of accepting EU “aquis”, Slovenia was gradually losing control of economic policies. By entering EU in May 2004 and ERM2 in July 2004, Slovenia also formally lost its monetary policy and gave in a large part of fiscal policies. In a decade, a newly born national economy turned again to a regional economy. The entry in EU and EMU coincided with the “gambling” period; in four “gambling” years 2005-2008, characterized by high but also extremely unbalanced growth, “the success story” became
questionable. Indeed, after years of steady convergence towards EU average in terms of GDP per capita, small and very open economy was severely hit by the global financial crisis. The imbalances from the gambling years, growing political instability, and social discontent have also severely hindered recovery.

Graph 1
Economic development of Slovenia
(index, 1990=100)

Slovenia’s experience after the euro area entry could serve almost as a textbook example of possible outcomes. For example, rounding up of prices and correction of relative prices which had been under control before conversion to euro contributed to inflation which was however pushed upwards also by the increase of world oil and agricultural products prices. Previous constant growth in the Slovenian share of exports in EU exports disappeared and turned to stagnation of the share which could be a consequence of the disappearance of exchange rate policy. Unprecedented increase of current account deficit which followed the entry can be explained by relaxation and replacement of “old fashioned” philosophy that one can succeed by working hard with “modern” philosophy, by which wealth can be most efficiently created by »financial deepening«, looking for »opportunities«, and buying securities at home and abroad; savings turned to speculations. GDP growth strengthened to 7 percent per year due to 15 percent growth in construction sector and financial services. This was enabled by credits growing at the rate of 30 percent per year, and after entering euro area, at the rate surpassing 40 percent per year. The banks were enthusiastic to cooperate in the “gambling” by borrowing cheap
money in EU or acquiring it from their mother banks; the inflow of capital in 2007 reached 12 percent of GDP, half of it was used for buying securities abroad. Net foreign debt increased from 0 € in 2005 to 10 billion € at the end of 2008 when the crisis hit.

The global financial crisis did not affect Slovenia until the end of 2008. But when the financial and economic crisis deepened, the very open Slovenian economy was unable to avoid the decline. Manufacturing companies were hit by the drop of foreign demand, crippled investments congested construction activity. In 2009, GDP fell by 7.8%, exports by over 15%, gross fixed investments by more than 30%. Active use of fiscal policy helped to make the fall in GDP in 2010 less than it would otherwise have been; the costs were high general government deficit and large increase in public debt.

The crisis in domestic demand deepened in 2011, when government consumption declined alongside the contraction in investment and household consumption. The only contribution to GDP growth came from net trade surplus created by export-oriented manufacturing industries and weak domestic demand for imports. In 2012, economic activity in Slovenia declined again much more than in the euro zone. The decline was the result of an accelerated contraction in domestic consumption, caused by government austerity measures, difficult access to financing, and a high level of uncertainty. Yet more significant drop in GDP was again prevented by the positive contribution of net exports; large current account surplus was largely a result of the narrowing of the merchandise trade deficit. After five years
of the financial crisis, the Slovenian economy slid into deeper recession again in 2013; the reasons for the second wave were over-leveraging in the non-financial companies and austerity measures.

1.2. Creation of the financial system

The search for monetary independence of Slovenia began in June 1990 and concentrated on three issues: the consequences of unilateral decisions for the functioning of the financial system and for the relations with other countries and international institutions; the possibilities of a monetary system in a confederation which was at a time considered a viable political solution for Slovenia in Yugoslavia; and the prospects of eventual monetary independence. Actual developments between June 1990 and October 1991 reveal uncertainties and confusion. Already in October 1990, nameless provisional notes were secretly printed, and the debates shifted to the pattern and the most appropriate moment for the introduction of the Slovenian currency. The preparations for monetary independence of Slovenia were at the same time accompanied by attempts to handle the repercussions of a fixed overvalued Dinar and to cope with advancing hyperinflation. These attempts are best illustrated by the Introduction of a Parallel Currency Act drafted on February 4, 1991, which envisaged a parallel currency pegged to the Austrian Schilling; a new currency would enter circulation through foreign transactions and would float against the Dinar. The concept of parallel currency was abandoned in favor of "the certificate of import privileges" solution which was less risky and would not expose Slovenian banks to the reactions of the federal authorities. The system functioned in the following manner: an exporting company, while obliged to sell foreign exchange to a bank at the official fixed exchange rate 7 Dinars = 1 DEM, would also receive a “certificate” which was saleable and would allow its buyer the access to foreign exchange. The fixed exchange rate plus the price of the certificate totaled flexible exchange rate. Earlier, in the middle of 1990, black market of foreign exchange for individuals was abolished by its de facto legalization; anybody possessing foreign exchange (mainly guest workers in Germany and Austria coming from Croatia and Bosnia) could sell it on the streets of Slovenian towns at a market exchange rate which was fluctuating at the level twice the official exchange rate. This created an inflow of foreign exchange to and outflow of Dinars from Slovenia, and also an undeterminable amount of “foreign exchange reserves” kept by population at their homes or in Austrian and Italian banks. After the so called “break in” the Yugoslav monetary system by Serbia at the end of 1990, Slovenia hastened in preparing acts for its own monetary system; all crucial acts were prepared in spring of 1991. The creation of the monetary system was interrupted for three months in July 1991 by Brioni ceasefire to allow for negotiations on the future of Yugoslavia. Nothing happened and on October 8, Slovenia introduced its own currency, using provisional notes for transactions in cash. Despite uncertainties and confusions before, the conversion from Dinar to a new currency Tolar was very smooth.
The Bank of Slovenia was established as the central bank within the framework of the legislation promulgated on 25 June, 1991, when the Bank of Slovenia Act (BS) was adopted together with the Basic Constitutional Charter on Independence and Sovereignty of the Republic of Slovenia and the Constitutional Act on the Implementation of the Basic Constitutional Charter. Article 152 of the Constitution of the Republic of Slovenia defined BS as independent central bank responsible directly to the Parliament.

The responsibilities of the BS were traditional: stability of the national currency, liquidity of the banking system within the country, and general liquidity of the country with foreign countries. In order to carry out these tasks, the BS regulated money supply, liquidity of banks and savings banks, general liquidity in payments abroad, supervised banks, issued banknotes and put coins and banknotes in circulation, guaranteed for bank deposits of natural persons and carried out some financial services for the government. The BS also carried responsibilities and competencies set forth by the Banks and Savings Banks Act, Foreign Exchange Transactions Act, Credit Transactions with Foreign Countries Act, Pre-rehabilitation, Rehabilitation, Bankruptcy and Liquidation of Banks and Savings Banks Act and Agency for Deposit Guarantees Act.

Establishing monetary system involved a choice between a fixed and floating exchange rate. While economic theory does not provide a definite answer which is preferable, majority of experts supported the view that fixed exchange rate system would suit a country in transition better, or they proposed crawling peg or currency board as appropriate possibilities. Exchange rate regime and ensuing macroeconomic stabilization patterns were, beside privatization, fields of heated controversies. The "pegging versus floating" issue also reflected two opposite approaches to transition in Slovenia: a radical and a gradualist. The "shock therapists" supported by foreign advisers suggested an overwhelming package encompassing price stabilization, fixed exchange rate, balanced budget, administrative restructuring of the manufacturing and of the banking system, and centralized privatization be part of the package of measures for independence. The gradualists suggested that economic policy remains funded on a gradual construction of market institutions and separation of political independence from macroeconomic stabilization. There would be no formal stabilization program and the government would have only indirect role in privatizing and restructuring of the economy. Economic policy instruments of this approach would be firm but flexible wage policy,

3 For example, a document "A Program for Economic Sovereignty and Restructuring of Slovenia" of March 21, 1991, proposed 10:1 conversion rate of the Dinar to a new currency, its pegging to the German mark, ECU or a basket, to assure a nominal anchor for a shock therapy stabilization program. The government group changed their views in favour of unrestricted floating in a Memorandum on October 8, 1991, when the managed floating exchange rate system was already introduced.
restrictive government spending enhanced by budget deficit, if required, monetary policy enabling tolerable liquidity, flexible exchange rate regime, reliance on foreign equity capital, and concessions for investments in infrastructure. It was argued that such policy would result in a smaller loss in product and lower unemployment on the account of higher inflation. Gradualists, who gathered in the governing board of the central bank, prevailed. However, Slovenia opted for floating for a very practical reason; fixed exchange rate could not be preserved. First, the central bank had no foreign exchange reserves to defend the fixed rate. Secondly, monthly! Inflation in October 1991 was 21.5 per cent. A moderate initial devaluation would therefore be overridden by inflation immediately while a large devaluation would stimulate inflation and again endanger the fixed rate. Thirdly, it was impossible to determine the starting equilibrium exchange rate in a new country. Fourthly, pegging would, in such circumstances, hinder accommodations of the equilibrium real exchange rate to a newly required volume of trade and trade patterns. Slovenia thus established a system of managed floating; the experiences which followed proved that managed floating was the right choice.


Most of financial regulation was prepared in the beginning of 1991 following the so called break in the monetary system by Serbia when it became certain that Slovenia will have to establish its own monetary system. The regulation was adopted by the parliament in the package of six acts together with the proclamation of independence in June 1991. Many provisions of Basel I were encompassed in the regulation though Bank of Slovenia (BS) was not a member of BIS.

Foreign exchange shortage used to be a kind of “normality” in a socialist shortage economy, a pillar in creating financial system prior to independence and a reason for extreme cautiousness observed in the initial BS regulation. Namely, when the new currency Tolar was introduced BS had no foreign exchange reserves, economic situation was extremely unstable and it was not possible to determine the rate which would assure balance of payments objectives. The rate 32 Tolars for 1 DEM was used as initial rate and it was supposed to float with inflation. Floating quickly led to a high positive current account balance, and Slovenia soon faced abundance rather than shortage of foreign exchange. Actual development thus enabled very quick elimination of initial restrictions such as mandatory sale of 30 percent of foreign exchange to BS. BS regulation nevertheless remained cautious regarding foreign exchange liquidity of the banks. The main reason for the restrictions of capital flows was prevention of real appreciation of the Tolar. Base money was namely created through foreign exchange transactions and steady over-supply of foreign exchange required constant sterilization of foreign exchange inflows by BS bonds. Current account transactions were free, so were also transactions related to foreign direct investments. This was not the case with foreign portfolio investments which
increased sharply following the relatively good country risk rating assigned to Slovenia for the first time in 1996 and relatively high level of domestic interest rates. Given small currency area and limited possibility of the BS to neutralize any big-scale pressures of capital inflows on the exchange rate, the BS required that non-resident portfolio transactions be channeled through custody accounts with fully licensed domestic banks and with committed long-term portfolio investments. BS also requested mandatory reserves of foreign exchange by banks (foreign exchange minimum) in the form of liquid assets on the accounts with first-class foreign banks, obliged banks to balance their foreign exchange assets with foreign exchange liabilities, and introduced a non-interest-bearing Tolar deposit on non-trade related loans taken abroad.

The provisions dealing with the cross border competition and permitted activities were scarce. A bank could be set up by domestic and foreign legal and natural persons and foreign bank could establish a branch as a legal person, business unit or representative office. Contrary to other CEE countries, there was no much demand for establishing foreign banks in Slovenia which can be explained by the reforms of the banking system in Yugoslavia. With these reforms, banks were functioning as banks elsewhere, and they had well defined “owners” (non-financial companies). In addition, there were uncertainties linked to the rehabilitation of the banking system between 1993 and 1997.

The provisions which were directly or indirectly related to capital adequacy for banks and savings banks were set in the Banks and Savings Banks Act ⁴. From December 1993, banks should use the methodology of the Committee on Banking Regulations and Supervisory Practices in Basel (Basel I). From August 1st, 1994, the generally accepted level of capital adequacy was put to 8%. BS also adopted new rules on the method of calculating the capital adequacy of banks regarding classification

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⁴ Banks should operate according to the principles of liquidity, safety and profitability (Article 4). The capital for establishment of a bank was set to at least 35 million Tolars in cash. To keep the real value the minimum amount of capital in the form of cash would be determined by BS (Article 9). BS determined the conditions for the operation of a bank and issued an unlimited or a limited operating license. To secure its obligations to the creditors and the entrusted assets banks were required to have an adequate guarantee capital and to adjust their business to the criteria laid down by the BS. The guarantee capital should be of at least the amount of the initial capital (Article 22). A more detailed definition of the different forms of guarantee capital was to be set by BS (Article 23). The amount of total assets and off-balance sheet items of assets, distributed and weighted by level of hazard, should not exceed 16 times the regulatory capital of the bank (Article 26). The bank's investments in land, buildings, business equipment holdings in other banks and non-banking organizations should not exceed the regulatory capital, while these investments which the bank obtained on the basis of realizing arrears should not be considered to be investment in land, buildings, business equipment holdings in other banks and non-banking organizations in the first three years after the acquisition (Article 28). To ensure the safety of operations the bank had to make provisions against potential losses arising from risky investments (Article 29) Banks, savings banks and savings co-operatives were obliged to operate so as to maintain their solvency; the detailed criteria for maintenance of liquidity were set by BS (Article 38). Banks were obliged to have minimum reserve holdings with BS depending on the type of liabilities.
of balance sheet assets and off-balance sheet items and the establishment of provisions for credit risk. Banks had to comply with the provisions on the large and maximum loan and on the total amount of all loans. A bank, which collected deposits, had to insure them with authorized institution up to the amount prescribed by the Ministry of finance.

Crisis Management Pre-rehabilitation, Recovery, Bankruptcy and Liquidation of Banks and Savings Banks Act provided solutions for handling of crisis in the banking system. Indeed, with the creation of an independent state the potential need to bail out some banks turned to reality. The major burdens were bad loans to companies in Slovenia and other former Yugoslav republics before transition, and foreign currency deposits of population. The capital adequacy was the basic criterion in the assessment of the needed recovery; according to it, two largest banks were insolvent. Actual crisis management procedure was introduced by The Bank of Slovenia Order on the Recovery of LB d.d. (January 27, 1993) and KBM d.d. (March 30, 1993). BS together with a newly established Agency for the Rehabilitation of Banks opted for a gradual introduction of the procedures in individual banks to the extent and dynamics in the current situation in available public financing, and monetary framework. The procedure consisted of: writing off current losses against capital, replacing bad assets with government bonds, transferring of assets to liabilities in the form of subordinated debt of former owners, recapitalization, and transfer of ownership to the Agency. Such a recovery procedure implied (at least temporary) nationalization. Replacing bad assets of banks with bonds solved the problem of insolvency and improved income, but did not solve the short-term liquidity problems. Initially, the banks were only able to meet their obligations by making use of the BS’s liquidity loans. The two banks were gradually able to comply with prudential rules, their cash-flow and liquidity improved significantly during 1996; they were actually able to manage their own liquidity and concluded the year 1996 with profit and return on assets and equity well above the average. The BS therefore released them from the recovery process; the state owned banks could be privatized but have been not.

One more issue is linked to the recovery procedure. In 1994, it became apparent that there were no prospects for rapid conclusion of the negotiations on financial assets and liabilities of the former state. National Assembly of the Republic of Slovenia therefore passed Constitutional Act on the Constitutional Act Implementing the Basic Constitutional Charter on the Independence of the Republic of Slovenia (27 July 1994) and established NLB d.d. and NKBM d.d., which took over the

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5 Agency of the Republic of Slovenia to insure deposits in banks and savings banks was created by a special act adopted as a part of the financial package in June 1991. Agency was to be a specialized financial institution which was to be financed by deposits of the banks and by state budget to ensure deposits in the banks in cases of bankruptcies. Banks and savings banks were required to pay deposit insurance premium in proportion of insured deposits while the amount of the premium was to be determined by the agreement between Ministry of finance and BS. However, the agency was never established and provisional solution according to which BS would play its role on behalf of the state was to be applied for such cases.
operations of \textbf{LB d.d} and \textbf{KBM d.d}. By it, the credits and liabilities of the former federal institutions, as well as obligations to depositors from other republics were retained by LB d.d. and KBM d.d. The issue has remained unresolved and the rather shortsighted decision has become the subject of law suits in domestic and international courts.

To cope with the consequences of extremely high inflation which required high nominal interest rates, Slovenia used \textbf{indexation} which was inherited from Yugoslavia. Real interest rates were defined as the real component above the indexation rate (Base Rate - BR, in Slovenian “temeljna obrestna mera” TOM) which was determined by inflation rate. As BS pursued stability of real exchange rate policy as the major goal, gradual lowering of inflation was mainly a consequence of increased competition. Therefore, BS was reducing base rates gradually and in line with declining inflation and by gradual de-indexation of its monetary instruments. In 1995, BS abolished indexation for its instruments with maturities of less than 30 days, and introduced a three-month average of inflation as revaluation clause for all other instruments. In February 1996, the revaluation clause was extended to four months’ average, and in December 1996 to six months’ average. Later, the reference period for calculation of BR was extended to 12 months. In September 1998, BS issued a 270-days bill at a nominal rate equal to the indexed rate for the same instrument, and in January 1, 1999, BS abolished the 270-day instrument at an indexed rate of interest. These contributed to a reduction in the volatility of nominal interest rates, and the movements thereof became more closely linked with the real rate rather than with current movements of retail price inflation. The government treasury followed the example and issued the bonds at a nominal interest rate.

3. \textbf{Adaptations to and acceptance of EU regulation, 1999-2007}

One of the rationales for the independence of the country was easier access of Slovenia to European associations, EU in particular. Negotiations with EU began already in 1992. They were followed by the \textbf{Association Agreement} in June 1996. Before all EU member countries ratified the Association Agreement, the \textbf{Interim Agreement} on trade and trade-related matters was used. In January 1997, EU introduced full liberalization of trade in industrial and agricultural products; Slovenia did that gradually up to the end of 2001. The agreement contained legal clauses and stipulations on capital flows, co-operation in the field of finance, prevention of fraud, etc. The core of the financial regulation for the new period was set by a new \textbf{Banking Act} in 1999 which was passed assuming that Slovenia will become a member state of EU and EMU. This implied that banking legislation should be fully harmonized with corresponding directives and also with the Core Principles for Efficient Banking Supervision adopted by the Basle Committee on Banking Supervision in 1997 regarding: establishment of a bank, definition of financial services, common standards for banking license,
management, establishment and functioning of foreign banks, capital adequacy rules, identification and measurement of credit risk, stipulations on large exposures, stipulations on management of liquidity risk, interest rate risk, currency risk, and other market risks, limited investment of banks in equity and in real property, supervision of banks and banking groups. According to the Banking Act, a bank could only be established as a shareholders company. The core capital of the bank consisted of: paid-up share capital and share premium, unless paid-up share capital and capital surplus were based on the cumulative preference shares; reserves; retained earnings from previous years; profit for the current financial year, subject to a limit of 50% of profit after tax and other levies charged to profit; provisions for general banking risks; and other items which are by their nature capital. In calculating additional capital bank should take account of the following items: capital and surplus of capital paid up on the cumulative preference shares; subordinated debt instruments, other items which are by their nature debt instruments. The bank's capital had to be at least equal to the sum of: capital requirements calculated using the minimum capital ratio, capital requirements for overstepping state participation in the capital of non-financial organizations, and might never be less than the minimum amount of share capital. The minimum capital adequacy ratio was to be at least 8%. The value of banks' investments in land, buildings, equipment, and financial assets arising from participation in the capital of non-financial institutions might not exceed the total amount of capital. In the investment banks the capital of non-financial organizations should not exceed 60% of the bank's capital; the investment in the first three years following the acquisition, were not considered investments acquired by the bank.

In 1999, the government made a commitment that the legislative framework of Slovenia concerning free capital flows will be harmonized with the “acquis communautaire” before the date of the country’s accession to the EU. The agreement signed by Slovenia and the European Community and its Member States came into force on February 1st, 1999. A four-year transitional period relating to controls on short-term capital movements was agreed while the lifting of sector-specific restrictions was linked to amending legislation governing the respective areas. A significant step towards alignment with the “acquis” in capital movement liberalization was made by implementing the new foreign exchange legislation in April 1999, which lifted a number of restrictions in the field of inward and outward capital flows. By the Foreign Exchange Act, cross-border credit transfers were completely liberalized, though some restrictions in short-term capital movements remained. BS liberalized borrowing abroad and kept few controls which referred to short-term capital flows. In response to the appeal by the European Union to liberalize capital movements prior to accession, BS adopted a timetable for the liberalization of cross-border capital movements and made a commitment to abolish the existing restrictions no later than by the milestones set out in the timetable. Major changes were introduced in 2001 and 2002. On January 1st, 2002, all restrictions on purchases of non-
residents in the domestic money market were lifted and transfers of domestic and foreign cash into and out of the country were fully liberalized if they were in accordance with the **Money Laundering Prevention Act**.

On July 17th, 2002, a new **Bank of Slovenia Act** came into effect. The Act established the core aim of the BS as price stability. While ensuring price stability, the BS should also support general economic policy and promote financial stability while adhering to the principles of an open market economy and free competition. The BS continued with efforts to ensure the harmonization of Slovenian with the EU regulation and the preparation of further negotiating positions with regard to the freedom to provide services, the free movement of capital, etc. Negotiations on Slovenia’s entry to the EU were concluded in December 2002. Entering EU and EMU implied harmonization of extremely cumbersome financial regulations.6

After accession, Slovenia was required to act in accordance with the ultimate EU goal of introducing the euro. Less than two months after joining EU, on June 28th, 2004, Slovenia entered the ERM II regime; the central rate was set at SIT 239.64 to the Euro, the nominal exchange rate was allowed to fluctuate within a standard band of ±15%. On July 11th, 2006, the council of EU finance ministers passed a resolution, abolishing the derogation, and a resolution on the Tolar-Euro conversion rate which was set at the rate at which Slovenia entered the ERM II in 2004. The final phase of preparations followed in the second half of 2006. The BS ceased to independently implement monetary policy on December 31st, 2006 and began implementing the single monetary policy of the Euro-system. Banks’ balance sheets and all customer accounts were converted by the afternoon of January 2nd, 2007 as planned. The transition was smooth; population and economy adjusted quickly to the new currency. As expected, there were some cases of prices being “rounded up”, particularly in the service and catering sectors7.

The third **Banking Act** (Official Gazette of RS, no. 131/06) was passed when Slovenia was in the ERM II regime and preparing to enter EMU on January 1st, 2007. The major reason for the adoption of the new **Banking Act** was to comply with EU directives such as Directive 2006/48/EC and Directive 2006/49/EC, Council Directive 86/635/EEC and Directive 94/19/EC. They brought new complex standards, the so-called Basel II. Transfer arrangement in the act called for extensive changes in key standards, the so-called Basel II. Transfer arrangement in the act called for extensive changes in key standards, the so-called Basel II. Transfer arrangement in the act called for extensive changes in key

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6 This is evident by, for example, comparing three consecutive acts on banking in a short period of fifteen years; Banks and Savings Banks Act (1991) had 5006 word, Banking Act (1999) 25185 words, and Banking Act (2006) 47532 words.

7 According to most estimates, the introduction of the euro contributed 0.3 percentage points to inflation, partly in December 2006 and the remainder in subsequent months.
areas or amending legislation in almost all chapters of the previous act. It was therefore considered more efficient and transparent, that, instead of a change in the Banking Act, this was done with the new act. Article 2 explicitly transmitted provisions of the Directive 2006/48/EC and Directive 2006/49/EC. The minimum amount of the share capital of a bank was put to € 5,000,000. To curb excessive concentration of credit exposure to a single client and a group of connected clients in addition to large exposure limits of 25% and 20% the act introduced a 10% limit in exposures to persons in a special relationship with a bank. Under the new deposit-guarantee scheme drafted in line with the EC Directive on Deposit-Guarantee Schemes (94/19/EC) and determined by provisions of the Banking Act 1999 which became effective on January 1st, 2001, the responsibility for repaying eligible funds to the public rests with banks and savings banks whose registered office is within Slovenia. Detailed standards were elaborated and prescribed by BS. Participation in the deposit-guarantee scheme was obligatory for all banks, savings banks and savings and loan undertakings authorized by the BS to provide banking services including accepting deposits, as well as for branches of banks with the registered office outside the territory of the Republic of Slovenia, which are partly or fully included in the host country deposit-guarantee scheme. Deposits in banks and saving banks with the headquarters in Slovenia were covered up to EUR 100,000. The calculation of the guaranteed deposit amount takes into consideration the total balance of deposits of an individual depositor expressed in Euros or foreign currency in a bank or savings bank on the commencement date of the bankruptcy procedure for that bank or savings bank.

One of the features of the Slovenian financial market has been the prevalence of monetary financial institutions; the share of non-monetary financial institutions adds up to between 25% and 30% of aggregated assets of the financial system. At the end of 2013, the assets of monetary financial institutions amounted to 71.3 percent of financial assets, while the share of non-monetary financial institutions which included investment companies, mutual funds and insurance companies, mutual pension funds, pension companies, and insurance agencies was 28.7 percent. The primary securities market remained underdeveloped. By far the dominant share issuers are non-financial companies (78% of the total value), followed by banks, other financial intermediaries and insurance agencies, while the largest group of shareholders are non-financial companies, followed by households, the government, other financial intermediaries, the rest of the world, banks, and insurance agencies. By far the most important bond issuer is the government, followed by banks, non-financial companies, and insurance agencies. The main holders of bonds are banks, insurance agencies, households, the government, non-financial companies, other financial intermediaries, and the rest of the world. The

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8 In line with the Transformation of Authorized Investment Corporations Act, privatization funds established in 1992 as one of the pillars of privatization had to convert into investment companies and/or ordinary public limited companies by the end of 2003.
entry to EU and EMU required changes in other acts regulating financial sector. The newly passed acts therefore usually began with explicit acceptance of EU directives.

One of the reforms in the financial system was the migration of accounts of legal persons from the Agency for Payments to banks. Namely, before transition, accounts of legal persons used to be with Agency for Payments which executed all payments between legal persons within the country. The reform process began in 1994, when the foundations of the project were put in place and the project was taken over by the BS; strategic decisions were adopted in 1995 and operational plan for the new payment system was drawn up in 1996. The institutions involved in the reform were BS, Ministry of Finance, Agency for Payments, commercial banks, savings banks, Banking Association, and Statistical Office. To facilitate the migration, detailed guidelines for the migration of accounts of legal persons to the banking environment were drawn up. At the end of July 2000, the eligible banks obtained the special authorization granted by the BS and the Ministry of Finance, and September 11th, 2000 the migration of accounts commenced. The migration process was going on steadily and smoothly and the migration process was completed by the end of June 2002. The aim of the oversight of the payment system by BS was first to protect the financial system from the consequences of the financial difficulties faced by participants, and second, to ensure safety and efficiency in the operation of the system. In 2003, BS commenced preparation for connection to the pan-European payment systems TARGET and STEP2. Domestic payments are settled within the national system, while cross-border payments are connected to TARGET. Activities related with ensuring and maintaining the secure operation of domestic payment systems took place in 2003. On joining the EU, Slovenian banks got the opportunity to join the STEP2 payment system, managed by the Euro Banking Association (EBA) for processing low-value cross-border payments in Euros. Majority of banks were however in favor of joining STEP2 via the BS. On November 8th, 2004 BS became a direct participant in the STEP2 system, with the banks participating via the BS having indirect participant status.

4. The crisis and the instability enhanced by regulation (2007-2013)

The financial turmoil, especially a lack of confidence and a considerable decrease in interbank lending badly affected Slovenian banks which had borrowed abroad extensively during the “gambling period” preceding the crisis. The effects were enhanced by high banking orientation of non-financial

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9 A favorable economic climate in Europe and the resulting high growth in foreign trade contributed to economic growth which exceeded the macroeconomic equilibrium output potentials. It was driven by high investment growth, particularly in construction works and financial deepening partly due to access to “unlimited” amount of money after entering EU and EMU and convergence of domestic interest rates with European interest rates.
companies which financed themselves almost entirely via bank loans, while domestic savings of households only partly passed through to banks. Instead, a lot of domestic savings went through non-banking financial intermediaries abroad, and returned in the form of bank borrowing. Since October 2008, banks were unable to borrow abroad under the same conditions as they did before; the maturities and interest rates on loans deteriorated, resulting in a drop of loans to the corporations. By the crisis, their virtual wealth was devastated while credit obligations remained to be served. Due to the drop of economic activity, more and more non-financial companies became unable to serve their obligations, more and more loans turned to bad loans. Banks, openhanded and imprudent during the gambling period, became thrifty and prudent or could not provide credits because of their own indebtedness. BS also lenient before the crisis became hard-hearted. The level of bad loans at home and non-performing investments in former Yugoslav republics began to increase. For a while, banks maintained their stock of lending which was enabled by expanded ECB supply of liquidity at a fixed interest rate with full allotment and a maturity of up to 1 year, and the pool of securities eligible as collateral for loans. Important for the maintenance of bank balance sheets was government borrowing abroad and depositing the money in the banks. It did not suffice; the consequences of the recession were soon seen in the deterioration in the banking system’s investment portfolio and in the need for loan reprogramming in the sectors which were hit hardest by the recession. Foreign banks began to squeeze crediting by reducing liabilities to their mother banks, while large domestic banks faced three problems: repayment of loans abroad, tougher rules on capital adequacy by BS, and political demagogy against crediting “taikuns” which frightened the bankers from restructuring credits and helping their clients; it was safer to do nothing.

The most notable feature of the banks’ operations in 2010 was the decline in total assets and overall operating loss. The banks were repaying liabilities to banks abroad and to ECB which had increased sharply in 2009, government reduced its deposits, while only a modest increase in deposits of households was achieved. The banks adapted by reducing their investments in securities, and by curbing growth in lending to non-financial corporations. The gap between credit demand and creditworthy demand widened, the arrears and non-settlement of liabilities increased. The deterioration in the quality of the credit portfolio and the resulting unavoidable increase in impairment and provisioning costs created the banks’ losses. The downturn in economic activity in 2012 resulted in lower corporate and household demand for loans and the tightening of the banks’ loan collateral standards, and in an increase in funding costs which the banks passed through into higher loan costs. The main factors affecting the balance of financial account in 2012 were continuing repayments to the rest of the world. In a year, the banks’ net repayments of liabilities on the wholesale financial markets amounted to 10% of GDP. The banks compensated for the loss of international sources of funding
primarily by borrowing via the ECB’s 3-year long-term refinancing operations (LTROs). At the end of 2012, they amounted to EUR 4 billion or 8.7% of the banks’ total liabilities, while deposits of non-financial companies and households with 51.7% remained the most important source of funding.

The crisis revealed two weaknesses: the banks’ over-dependence on funding on the international financial markets, and high debt-to-equity ratios in corporations. The low level of equity implied a relatively low threshold for the coverage of business risks by the owners, and a large likelihood that risks will have to be assumed by creditors. Because domestic bank loans account for 59% of corporate debt, they are heavily exposed to credit risk during a lengthy economic recession. Corporations faced the problem of how to reduce high indebtedness, illiquidity, and limited alternative financing. Some large corporations sought financing abroad, primarily in the form of trade credits and loans and there were few successful offerings of commercial papers by large corporations, while SMEs did not have any financing possibilities. Corporate leverage remained high, with a debt-to-equity ratio of 135%. The banks were also forced to restructure their funding. Previous excessive funding on international financial markets and aggressive lending to increase or retain market share at home, proved to be fatal. A contraction in their balance sheets and the tightening of credit standards was the result.

At the beginning of 2012, the proportion of the banking system’s total classified claims that were in arrears more than 90 days reached 14.6%, while exposures to corporations in bankruptcy accounted to 5.2% of claims. With only 3.8% of their classified claims more than 90 days in arrears, households remained relatively low-risk, partly due to very low general level of indebtedness. Large domestic banks had the highest proportion of non-performing claims. The banks ended 2012 with the largest loss since the outbreak of the financial crisis. The main reasons of the pre-tax loss of EUR 771 million were an increase of 32% in impairment and provisioning costs and a decline of 13% in net interest income. Given the deterioration in the quality of the credit portfolio and the contraction in credit activity, the banks’ income risk was becoming increasingly important. Despite a fall in reference interest rates the banks’ rising funding costs resulted in high lending rates for corporations, and declining net interest margin.

BS, accepting the idea that in the adverse economic situation it is vital to maintain the capital adequacy of the banks, tried hard to achieve that by harsher capital requirements. A contraction in turnover was unavoidable outcome. Although the banks improved their capital structure the shortfall on the capital adequacy increased; it was not the result of a decline in capital, but primarily of imposed differences in risk-weighted assets calculations.
Two fields of banking regulations faced frequent changes during the crisis period: regulation of deposit guarantee and regulation of capital adequacy.

In the package of measures aimed at mitigating the effect of the financial turmoil, the new Banking Act (Official Gazette, No. 109/08; ZBan-1B) in November 2008, temporarily (until the end of 2010) introduced an unlimited deposit guarantee in the event of the bankruptcy of a bank or savings bank. Since banks and savings banks guaranteed a net deposit up to the amount of EUR 22,000, while Republic of Slovenia guaranteed the remainder above this amount, the balance of guaranteed deposits had to be determined separately. The majority of changes to secondary legislation of deposit guarantee in 2010 were the results of amendments to the banking acts ZBan-1D (Official Gazette, No. 98/09), ZBan-1E (Official Gazette, No. 79/10) and the Consumer Credit Act (Official Gazette, No. 59/10; ZPotK-1).

The period is characterized by persistent changes in the capital adequacy regulation. In 2007, secondary legislation affecting banking supervision was issued primarily to continue harmonization with Directive 2006/48/EC. Emphasis in 2008 was on the examination and monitoring of the implementation of the new capital framework at banks and savings banks and the related calculation of capital requirements for credit and operational risk in the scope of Pillar 1 and the process of calculating the required level of internal capital in the scope of Pillar 2 of Basel II. Three directives were adopted in 2009 amending the banking directive (2006/48/EC) and the directive on the calculation of capital requirements for market risks. BS regulations required amending owing to the transposition of these regulations and the introduction of guidelines by the Committee of European Banking Supervisors. This brought about more significant changes with regard to the treatment of own fund instruments, large exposures and securitization, calculation of the capital of banks and savings banks, regulation on large exposures of banks and savings banks, regulation on calculation of capital requirements for credit risk in securitization, and the rules regarding the exposure of banks and savings banks to credit risk transfer. Most of the changes to banking regulations in 2011 were related to the transposition of Directive 2010/76/EU regarding capital requirements for the trading book and for re-securitizations, and the supervisory review of remuneration policies. Some of the provisions of this directive were transposed into the Slovenian legal system by the amendment of the Banking Act, the ZBan-1G (Official Gazette, No. 59/11), while the remaining provisions were transposed by the amendment ZBan-1H (Official Gazette, No. 85/11). Two other regulations were issued in August 2011 on the calculation of capital requirements for credit risk under the standardized approach and under the internal ratings-based approach. A broad package of regulations was adopted on December 2011 to amend the calculation of capital requirements for position risk, currency risk and commodity risk using an internal approach. Banks had to comply with stricter quantitative and qualitative
standards in the calculation of value-at-risk, and calculate additional capital requirements based on the calculation of value-at-risk for stress situations. In 2012 and 2013, a few key acts were adopted to facilitate the implementation of the measures for strengthening financial stability. **The Measures of the Republic of Slovenia to Strengthen the Stability of Banks Act** (Official Gazette, No 105/12; ZUKSB) was adopted on 28 December 2012. It and the implementing regulations dealt with the management of non-performing loans and other risk-weighted asset items of a bank. The Bank Asset Management Company (BAMC) was established by the Act aiming to ascertain efficient use and recovery of budget funds used for preventing the collapse of the banks, the stimulation of lending to the non-financial sector, and the establishment of conditions for the sell-off of the government’s capital investments in banks.

**The Act Amending the Banking Act** (Official Gazette, No 105/12; ZBan-1J) was also passed in December 2012. Its objective was to establish a special legal regime for resolving banking system issues resulting from limited possibilities for securing appropriate sources of funding to ensure capital adequacy. The Act followed the principles emphasized by the EC in its draft directive establishing a framework for rescuing and restructuring credit institutions and investment firms. In accordance with the ZBan-1J, the BS may as a supervisor adopt measures against a specific bank which breaches risk management and capital requirement regulations or also in circumstances which might identify the likelihood of the occurrence of such breaches. In addition, BS may act if it believes that the stability of the financial system is jeopardized.

**The Act Amending the Banking Act** (Official Gazette, No 96/13; ZBan-1L) entered into force on 23 November 2013. The Act primarily relates to measures which BS can impose on a bank, if increased risk arises and no circumstances are present which would indicate that the reasons for the increased risk will likely be eliminated in a reasonable period. Prior to the adoption of this Act, four emergency measures were available to BS: (a) appointment of an emergency administration for the bank, (b) sale of the bank’s shares, (c) increase in the bank’s share capital, and (d) transfer of the bank’s assets. This Act introduced a new emergency measure that may be used by BS by reducing share capital, and the cancellation or conversion of the bank’s hybrid financial instruments and subordinate debt into ordinary bank shares to ensure the coverage of its losses or to attain the required capital adequacy. The principle which should be followed is that an individual creditor cannot suffer losses greater than he would have suffered had the bank bankrupt. The new emergency measure complied with the Commission Communication on the Application of State Aid Rules to Support Measures in Favor of Banks in the Context of the Financial Crisis from 1 August 2013.
Economic recession revealed deficiencies in the banks’ risk management during the period of high economic growth which was enabled by credit addiction. When revenues of corporations declined and losses increased, the amount of non-performing claims began to rise. Claims to corporations (particularly in the construction sector and in holding companies) which increased enormously during the time of abundant credits, accounted for the largest proportion of non-performing claims. As the recession persisted, the difficulties with the repayment of bank loans spread to other sectors, particularly to corporations depending on domestic demand, while risks in the households sector remained low. The proportion of non-performing claims more than 90 days in arrears or rated in the lowest categories (D and E) reached 20.9% by October 2013, equivalent to EUR 9.5 billion. The banks had to increase impairments and provisions which amounted to EUR 5.1 billion at the end of October, or 11.2% of the banks’ total classified claims and which were decisive in the banks’ operating losses.

Measures to Strengthen the Stability of Banks Act (ZUKSB) passed at the end of 2012 set out possible measures to strengthen the banks: capital increases, the purchase of claims and the transfer of claims to Bank Asset Management Company (BAMC), guarantees by the Republic of Slovenia for liabilities of BAMC and special purpose vehicle (SPV) with a guarantee for needed liquidity to banks. On the EU Council Recommendation of June 2013 the European Commission requested the execution of an independent asset quality review and stress tests (bottom-up and top-down) for a representative portion of the banking system as a prerequisite for the transfer of claims to the BAMC and the approval of state aid. To ensure the “independence and credibility” of the review, the BS had to engage international consultants and real estate appraisers, who should conduct the reviews on the basis of methods and international standards used in comparable reviews. The objective of the comprehensive review was to assess the ability of the Slovenian banking system to withstand a sharp deterioration in macroeconomic and market conditions as projected for the future three-year period (2013 to 2015 inclusive) under the adverse scenario, and to determine the potential capital shortage in the case of the realization of such case. The reason for using such an extreme scenario was said to assess the robustness of the Slovenian banking system in the most adverse hypothetical developments. Ten banks and banking groups which together constitute approximately 70% of the Slovenian banking system were involved in the review. The review included an asset quality review and stress tests (bottom-up and top-down). The scope, conditions and contractors for the asset quality review and

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10 This part of the paper is based on: Report on comprehensive review of the banking system and associated measures, BS, 2013.
stress tests were determined by an inter-institutional committee after consultations with the European Commission (EC) and the European Central Bank (ECB). The contracting authority for the asset quality review for seven banks and the stress tests for all the banks included was the BS which also covered the costs while three banks included in the review measures (NLB, NKB, Abanka) had to cover the costs of the asset quality review themselves. The comprehensive review was coordinated and supervised by a Steering Committee comprising the BS, the Ministry of Finance, and observers from the European Commission, the ECB and the European Banking Authority (EBA).

The objective of the asset quality review was the verification of data completeness and integrity, a review of individual loans and their rating classifications, a collateral valuation and the identification of shortfalls in impairments and provisioning. The objective of the bottom-up stress tests was to determine the capital deficit/surplus of individual banks and the banking system under the conditions of the baseline and adverse macroeconomic scenarios for the three-year projection period (2013-2015), while the starting points were the balance sheet figures at the end of 2012. The bottom-up stress tests focused on the assessment of credit risk from performing, non-performing, and restructured claims, and risks (credit risk and market risk) from investments in securities. The credit portfolios assessed in these stress tests included lending to the domestic business sector and claims from off-balance-sheet liabilities to these sectors. The securities portfolio included financial assets held for trading, financial assets available-for-sale and financial assets held to maturity. The tests included three main elements of assessment: expected losses, a bank's loss absorption capacity and capital shortfall/surplus resulting from the surplus/shortfall of expected losses above expected available loss absorption capacity. The objective of the top-down stress tests was to provide a check against the results of the bottom up stress. The underlying assumption was that using the same macroeconomic assumptions and the same starting point as the bottom up stress testing exercise this can help to explain the bottom up results by analyzing and explaining the deviation between the two.

The macroeconomic scenarios for the stress tests were proposed by EC and ECB, while BS estimated the response of banking variables under the two scenarios. The baseline scenario was based on the EC’s spring forecast of macroeconomic developments and was revised downwards on the basis of macroeconomic figures for the first quarter of 2013. The scenarios envisaged a further contraction in economic activity in 2013 and 2014 as a result of further decline in investment, and gradual rise of unemployment. In the low credit demand environment and with banks repaying their liabilities, lending to private non-banking sector was expected to continue decreasing. Under the adverse

11 Deloitte and Ernst & Young were selected to conduct the asset quality review, while several foreign real estate appraisers conducted the real estate valuations. The firms selected to conduct the stress tests were Oliver Wyman (bottom-up) and Roland Berger Strategy Consultants (top-down).

scenario, Slovenia would undergo three years of severe economic recession. The drop in economic activity is in this scenario reinforced by structural weaknesses in EU member states, in particular the need to reduce fiscal imbalances and to implement structural reforms. Because of that, investors would demand higher risk premium for Slovenian government bonds, which triggers a re-assessment of the risk premium on other assets for example a drop in stock prices by 25% and a drop in residential house prices by almost 27%. The developments on the financial market would have adverse impact on domestic and foreign demand; corporations would reduce their investment expenditure and cut employment, which in turn induces households to limit their consumption. A decline in credit demand, both from corporations for financing investments and from households for financing current consumption and residential expenditure, together with constraints on credit supply caused by the banks’ difficulty in ensuring stable funding, would cause a further decline in lending to the private non-banking sector.

Table 5.1
Macroeconomic scenarios for the stress tests
(yearly growth if not indicated)

<table>
<thead>
<tr>
<th></th>
<th>baseline scenario</th>
<th>adverse scenario</th>
<th>actual</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>-2.7</td>
<td>-1.5</td>
<td>0.1</td>
</tr>
<tr>
<td>Private consumption</td>
<td>-4.8</td>
<td>-3.5</td>
<td>-1.2</td>
</tr>
<tr>
<td>Gross fixed capital formation</td>
<td>-6.0</td>
<td>-2.7</td>
<td>1.9</td>
</tr>
<tr>
<td>Net exports contribution</td>
<td>2.6</td>
<td>1.4</td>
<td>1.0</td>
</tr>
<tr>
<td>Employment</td>
<td>-2.6</td>
<td>-1.4</td>
<td>-0.3</td>
</tr>
<tr>
<td>Unemployment rate (%) of labor force</td>
<td>11.3</td>
<td>11.5</td>
<td>11.5</td>
</tr>
<tr>
<td>EURIBOR (3m, in bps)</td>
<td>25</td>
<td>50</td>
<td>79</td>
</tr>
<tr>
<td>10 year government bond yields (in bps)</td>
<td>602</td>
<td>682</td>
<td>702</td>
</tr>
<tr>
<td>HICP</td>
<td>1.9</td>
<td>1.4</td>
<td>1.5</td>
</tr>
<tr>
<td>Residential house price</td>
<td>-9.6</td>
<td>-4.3</td>
<td>-2.4</td>
</tr>
<tr>
<td>Current account balance (% of GDP)</td>
<td>5.0</td>
<td>5.4</td>
<td>6.0</td>
</tr>
<tr>
<td>General government debt</td>
<td>64.1</td>
<td>66.2</td>
<td>69.6</td>
</tr>
<tr>
<td>Credit volume</td>
<td>-7.2</td>
<td>-3.8</td>
<td>-1.9</td>
</tr>
<tr>
<td>Deposit volume</td>
<td>1.0</td>
<td>0.8</td>
<td>0.8</td>
</tr>
</tbody>
</table>

Source: BS, own calculations

The adverse scenario was built on very unlikely assumptions. It, for example, assumes additional 9.5% decline in GDP by the end of 2015, while the total decline since the outbreak of the crisis amounted to
10%. The cumulative decline of 18% in private consumption sharply exceeds the figure of 2.5% recorded between 2009 and 2012. The downward exaggeration of not only adverse but also of baseline scenario is also well seen in comparing actual data with baseline scenario data; for example, the actual yield on 10 year government bond at the end of March 2014 was to 340 basic points, and at the beginning of February 2015, only 140 basic points, the one used in baseline scenario for 2014 is 682 and for adverse scenario 820 basic points. Thus, one could easily say that very expensive operation was senseless and that the methodology was adapted to politically desired results of European authorities who have been trying to press Slovenia to “privatize”, indeed, to sell state owned companies to foreign companies. Thus. Airport of Ljubljana was sold to German Fraport, and Telekom to German Telekom.

The banks’ consolidated figures for the end of 2012 formed the basis for calculations of needed capital and recapitalization of the banking sector which cover a time horizon of three years (2013 to 2015 inclusive). The calculations were based on current capital regulations. Accordingly, the banks have to meet a Core Tier 1 capital ratio (as defined by the EBA) of 9% under the baseline scenario and 6% under the adverse scenario. All mitigating measures planned by the management boards (capital increases, transfer of credit risk from banks) for covering the potential capital deficit after the cut-off date (30 September 2013) were excluded from the calculation. The overall calculation of the stress test results was based on the BS’s definition of non-performing claims, which follows the EBA definition. Thus, all claims against customers rated D and E and classified claims against individual customers whose repayments are being made more than 90 days in arrears are classed as non-performing claims. Other major assumptions that had an impact on the estimate of banks’ loss absorption capacities are:

- the banks can first use liquid assets up to the amount of 15% of total assets to cover the deficit in funding, and only then seek new borrowing on the financial markets,
- after repaying the LTRO liabilities to the ECB in late 2014 or early 2015, the banks will continue to maintain debt at the ECB in the amount of no more than 3% of total.

The capital shortfall was calculated under both approaches as the difference between the expected loss, which primarily derives from credit risk, and the banks’ loss absorption capacity, which is the stock of impairments and provisions at the end of 2012 disclosed on the banks’ balance sheets, the estimated profit before impairments in the next three years, and the capital surplus over the minimum Core Tier 1 capital requirement.

Were the scenarios (baseline and adverse) assuming an additional sharp deterioration in the macroeconomic situation realized, the potential capital shortfall in the banking system (the eight banks included in the comprehensive review) would at the end of the three-year period (end of 2015) range as shown in Table 5.2:
Table 5.2
Results of stress tests for the banking system
(in millions €)

<table>
<thead>
<tr>
<th></th>
<th>Projected economic losses</th>
<th>Absorption Capacity</th>
<th>Capital shortfall</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>baseline</td>
<td>adverse</td>
</tr>
<tr>
<td></td>
<td></td>
<td>9% capital ratio</td>
<td>6% capital ratio</td>
</tr>
<tr>
<td>Top down</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>baseline</td>
<td>7369</td>
<td>4893</td>
<td>2725</td>
</tr>
<tr>
<td>adverse</td>
<td>8606</td>
<td>5326</td>
<td></td>
</tr>
<tr>
<td>Bottom up</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>baseline</td>
<td>8889</td>
<td>4843</td>
<td>4046</td>
</tr>
<tr>
<td>adverse</td>
<td>10364</td>
<td>5586</td>
<td></td>
</tr>
<tr>
<td>difference</td>
<td></td>
<td></td>
<td>1321</td>
</tr>
</tbody>
</table>

Source: BS Report

The difference between the capital shortfall according to two approaches: EUR 1.3 billion under the baseline scenario, and EUR 1.5 billion under the adverse scenario, is striking. It was created in the calculation of expected loss and much less in the assessment of the absorption capacity. The extreme results of bottom-up stress tests under the adverse scenario were used as key input to compute the banks’ capital requirements, assuming that they are more accurate since they are estimated relying on
more granular data. The individual results of the bottom-up stress tests for eight banks included in the comprehensive review are presented in Table 5.3.

The results of the bottom-up stress tests under the adverse scenario serve as the starting point for the assessment of the required capital increase at individual banks. The banks were classified into four groups with regard to the actions taken to date by the BS and with regard to the results of the review. In the first group, there are three banks in which BS required capital increase even before the beginning of the review and had state aid approved (NLB, NKBM, Abanka) by EC. Five banks in the second group might potentially have a capital shortfall by the end of 2015 (Banka Celje, UniCredit Banka Slovenija, Gorenjska banka, Hypo Alpe-Adria-Bank, Raiffeisen banka), nine banks in the third group were not included in the comprehensive review, two banks in the fourth group (Factor banka, Probanka) are subject to an orderly liquidation.

Table 5.3
Results of stress tests for eight banks
(in millions €)

<table>
<thead>
<tr>
<th>bank</th>
<th>Baseline scenario</th>
<th>Adverse scenario</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>mil. €</td>
<td>% of assets</td>
</tr>
<tr>
<td>NLB</td>
<td>1643</td>
<td>11%</td>
</tr>
<tr>
<td>NKBM</td>
<td>887</td>
<td>17%</td>
</tr>
<tr>
<td>Abanka</td>
<td>646</td>
<td>18%</td>
</tr>
<tr>
<td>Unicredit banka</td>
<td>23</td>
<td>1%</td>
</tr>
<tr>
<td>Banka Celje</td>
<td>327</td>
<td>14%</td>
</tr>
<tr>
<td>Hypo banka AA</td>
<td>189</td>
<td>10%</td>
</tr>
<tr>
<td>Gorenjska banka</td>
<td>249</td>
<td>14%</td>
</tr>
<tr>
<td>Reiffeisen banka</td>
<td>83</td>
<td>6%</td>
</tr>
<tr>
<td>8 banks</td>
<td>4046</td>
<td></td>
</tr>
</tbody>
</table>

Source: BS Report

The banks in Group 1 have restructuring plans, which were examined by the BS and EC together with the results of the stress tests and approval of state aid by EC. Their capital increased with the wipe out of qualified liabilities (shareholders and holders of hybrid and subordinated instruments). The three banks also transferred the majority of their non-performing claims to the BAMC. The banks in the second group had to draw up a capital strengthening plan that will demonstrate long-term viability, and to draw up measures to cover potential capital deficit. Should their actions (primarily an inflow of
capital from existing owners, a search for new investors, the sale of claims and other assets, and other actions to strengthen capital adequacy) fail by 30 June 2014, they will be able to request state aid in accordance with EC rules. BS will provide an assessment of capital risk for the banks in the third group 3 using the same approach as for the banks included in the comprehensive review. For the banks in Group 1 and Group 4, the money for the capital increases is being provided by the Government in line with the EU state aid rules and with the approval of the EC. At Abanka the capital increase will be carried out when the EC issues a final ruling. In three major banks the capital increase provided by the government will be an amount derived from the capital shortfall identified by the end of 2015 under the adverse scenario. The banks in Group 2 will draw fresh capital from existing owners (including foreign parent companies) or new owners, or will use other actions to strengthen capital adequacy. Should they be unable to strengthen capital themselves, they will be able to request state aid within the framework of the ZUKSB in accordance with EC rules. The BS is to ensure the solvency of banks facing temporary liquidity difficulties by acting as a lender of last resort in accordance with ECB rules.

Table 5.4
Overall projected fiscal effects
(in millions €)

<table>
<thead>
<tr>
<th></th>
<th>Capital increase in cash</th>
<th>Capital increase in non-cash contribution</th>
<th>Capital increase Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>NLB</td>
<td>1,140</td>
<td>411</td>
<td>1,551</td>
</tr>
<tr>
<td>NKBM</td>
<td>619</td>
<td>251</td>
<td>870</td>
</tr>
<tr>
<td>Abanka</td>
<td>348</td>
<td>243</td>
<td>591</td>
</tr>
<tr>
<td>Total</td>
<td><strong>2,107</strong></td>
<td><strong>905</strong></td>
<td><strong>3,012</strong></td>
</tr>
<tr>
<td>Factor banka</td>
<td>160</td>
<td>109</td>
<td>269</td>
</tr>
<tr>
<td>Probanka</td>
<td>160</td>
<td>16</td>
<td>176</td>
</tr>
<tr>
<td>Total</td>
<td><strong>320</strong></td>
<td><strong>125</strong></td>
<td><strong>445</strong></td>
</tr>
</tbody>
</table>

**Strengthening of the Banking Supervision** Reformed banking supervision at the EU level will also impact supervision in Slovenia. Indeed, the regulation on transition to the **Single Supervisory Mechanism** (SSM, Council Regulation No. 1024/2013) was adopted in Slovenia at the beginning of November 2013. According to it, ECB will assume supervisory tasks in full in November 2014. Until that time, the competent national authorities of member states will carry out the comprehensive assessment of credit institutions, the supervision of which will be assumed directly by the ECB. The comprehensive assessment will comprise three parts: an assessment of banking risks, an asset quality review, and stress tests for 130 credit institutions, including three Slovenian banks: NLB, NKBM and SID banka. With the assumption of responsibilities by the ECB, supervision will be carried out on the basis of standard methodologies in all member states. This is assumed to result in further stability,
transparency, and confidence in the banking system. It is uncertain that this will actually happen and the whole thing might result in enormous bureaucratic achievement only. New tasks that the new legislation imposes on the banking supervisor will request additional human resources and changes to the organizational structure and processes.

The existing supervisory which covers the processes, procedures and methodology of supervision, will be harmonized to a great extent with the SSM supervisory manual, including for those banks which will not be included directly in the SSM. Planned improvements to the existing methodology primarily relate to the introduction of quantitative indicators and qualitative estimates in the assessment of the banks’ risk profile. The system of micro-prudential risk indicators should be expanded and supplemented with macro-prudential risk indicators. The system of indicators should serve as the basis for monitoring the position of specific banks and the banking system as a whole, supervision, measures in line with legally defined powers, in terms of both micro-prudential and macro-prudential supervision, and potential decisions on the use of resolution mechanisms. The central loan register (CLR) should facilitate the effective exchange of data to a limited extent with other loan registers in the EU and between the users of the Slovenian CLR, with the aim of improving risk management. Also envisaged is the reform of the financial system in the direction of a single supervisor. A new structure of supervisory bodies could be established following the adoption of Solvency II rules in the new Act Governing Insurance and Stabilization of the Banking System. Let me just remark that more common sense could be a much better solution than expanding the rules, indicators and authorities.

Graph 5.1.

**Credits to the non-financial business sector**
The structure of bank funding, accumulated losses, continuous deterioration of the quality of the credit portfolio, and accelerated deleveraging by the banks raise the issue of a proper size of the Slovenian banking sector, both in terms of the number of banks and the size of assets under management. The consolidation of the banking sector with further contraction of the banking system can be expected. A total of 21 banks (and three savings banks) were operating in Slovenia when the financial crisis broke at the end of 2008; in the beginning of 2014 the number stands at 20, with two banks in the process of orderly liquidation. The number of banks is expected to decline to 15 or 16 by the end of 2015, the size of the banking system would remain at 140% of GDP but only 1.5 thousandth part of the euro banking system. The enormous drop of claims by the banking system caused by transfer of bad but also less “bad” loans to BAMC indirectly affects all the indicators as shown in Graph 5.1. The amount of credits to the business sector which reached 21.3 billion euro in the middle of 2011, was until the transfer to BAMC gradually reduced to 17.2 billion and by transfer to less than 14 billion euro, the loan deposit ratio (including loans to households) decreased to 1.3 and the capital adequacy ratio increased to more than 15 percent. The expectations that this will enhance credit activity and lead to economic recovery have proved to be wrong. The bankers remain overly cautious which can be explained by political and social atmosphere prevailing in the country. It is safer to do nothing than to take a risk of a mistake.

At the end of 2012, European Commission proposed banking union as a solution for the banking system in the EU. The accession of the member states to it would transfer decision-making on key banking policy to the supranational level. The idea of a banking union
supported by the ECB and IMF has been well received by the countries with the greatest problems in the banking sector and encountered resistance in countries with stronger economy. The four pillars would be: (1) standard banking rules at EU level, (2) single banking supervisor, (3) single deposit guarantee scheme, and (4) common rules to avoid bankruptcy of banks and a shift from the bail-out to the bail-in solution if banks find themselves in financial difficulties.

It is hoped that banking union would ensure capital stability, dispersion of risks, stable structure of funding and increased profitability, which would allow the banks to generate internal capital via retained earnings, mitigate the negative effects on lending activity, and enable banks to find it easier to access the wholesale funding market at acceptable prices. Lower funding costs would allow the banks to operate with a higher net interest margin, which would increase the profitability of the banking sector. The consolidation of the banking sector is also expected to bring synergies related to cost-efficiency through lower operating costs. Are the hopes in the benefits of the new banking union realistic? Will the banking union not face the fate of monetary and fiscal union. The former was a purely political undertaking with weak economic foundations encompassing countries which do not form optimal currency area and therefore turned to a burden when bad times arrived. The nearly forgotten fiscal union which does not encompass fiscal transfers turned to a meaningless fiscal pact rather than fiscal union. Will the new banking union not end as an enormous administrative institution which will generate more and more meaningless rules?

Introduction of a Parallel Currency Act drafted on February 4, 1991
Measures to Strengthen the Stability of Banks Act (ZUKSB) was passed at the end of 2012
Income Tax Act and Profit Tax Act
Bank of Slovenia Act,
Banks and Savings Banks Act,
Foreign Exchange Transactions Act,
Rehabilitation of the Banks and Savings Institutions Act
Declaration of Independence
Bank of Slovenia Act (BS) was adopted together with the Basic Constitutional Charter on Independence and Sovereignty of the Republic of Slovenia and the Constitutional Act on the Implementation of the Basic Constitutional Charter.
Banks and Savings Banks Act,
Foreign Exchange Transactions Act,
Credit Transactions with Foreign Countries Act,
Pre-rehabilitation, Rehabilitation, Bankruptcy and Liquidation of Banks and Savings Banks Act
Agency for Deposit Guarantees Act.
The Bank of Slovenia Order on the Recovery of LB d.d. and KBM d.d.
Financial Conglomerates Act (Official Gazette of RS, no. 43/06)
Directive 89/117/EEC
Payment Transactions Act (Official Gazette of the Republic of Slovenia, No. 30/02)
Banking Act (Official Gazette of RS, no. 131/06)
  Directive 2006/48/EC and Directive 2006/49/EC,
Directive 94/19/EC.
Directive 2002/87/
Financial Conglomerates Act (Official Gazette of RS, no. 43/06)
  Directive 89/117/EEC
  Directive 97/9/EC
  Directive 98/26/EC
  Directive 2001/34/EC
  Directive 2003/6/EC
  Directive 2003/71/EC
  Directive 2003/124/EC
  Directive 2003/125/EC
  Directive 2004/39/EC
  Directive 2004/72/EC
  Directive 2004/109/EC
  Directive 2006/48/EC
  Directive 2006/49/EC
  Regulation (EC) no. 2273/2003
  Regulation (EC) no. 809/2004 on prospectuses.
  Directive 2006/48/EC
  Directive 2006/49/EC.