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Financial regulation in Slovenia

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## Financial Regulation in Slovenia

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**Abstract:** The presentation of financial regulation in Slovenia and its adaptation to the EU regulation reveals the importance of understanding the rationales behind the changes of the regulation and their consequences. They both depend on social and economic environment in the country, on its history, and on existing economic and political situation. The same legal rules and institutions in a new market economy do not lead to the same results as in a developed old market economy. The performances crucially depend on norms and patterns of social behavior created over many years. Due to interplay of internal and external factors, four distinctive periods of Slovenian banking regulation could be distinguished with a clear pattern of transition from authentic Slovenian financial regulation, that is, the period of autonomous and powerful Bank of Slovenia, which was aware of the development of financial regulation elsewhere when creating and applying it in the country, to the period of gradual adaptations of Slovenian financial regulation to EU and EMU financial regulation. Affected by the 2008 crisis, Slovenia witnessed the period of often chaotic regulatory reactions of the Slovenian authorities, while the most drastic reform of Slovenian banking took place in 2013 and 2014.

**Key words:** Financial regulation, supervision, banking, transition economies, Europeanization, Slovenia.

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## 1. Preface

While analyzing changes in financial regulation in a country it is important to understand rationales for the changes of the regulation and their consequences. They both depend on social and economic environment in the country, on its history, and on existing economic and political situation. The same legal rules and institutions in a new market economy do not lead to the same results as in a developed old market economy. The performances namely crucially depend on norms and patterns of social behavior created over many years. This is to a great extent seen in the presentation of financial regulation in Slovenia and its adaptation to the EU regulation.

The paper on financial regulation in Slovenia and its adaptation to the EU regulation before the crisis and during the crisis 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; the period was dominated by formally and actually extremely autonomous and powerful Bank of Slovenia (BS) which however was aware of the development of financial regulation elsewhere (Basel I, for example) when creating and applying it in the country. The period of authentic regulation described in Part 3 was in the 1999-2007 period followed by gradual adaptations of Slovenian financial regulation to EU and EMU financial regulation; it is described in Part 4. The period of the crisis and often chaotic regulatory reactions of Slovenian authorities to it is presented in Part 5, while the most recent development of rather drastic reform of Slovenian banking, which took place in 2013 and 2014, is dealt with in Part 6.

## 2. Introduction

### 2.1. Creation of the country

While describing financial regulation of Slovenia one cannot avoid short introduction on the creation of the country and its financial system, and on the major decisions which



determined specifics of the regulation. Namely, creation of the country influenced the development of all aspects of financial regulation: (liberalization of capital movements, cross border competition, capital requirements, deposit guarantees, investment services, large exposures, supervision, and crisis management) and impending convergence towards EU regulation. Two distinct periods can be distinguished before the crisis; (1) initial period in which authentic regulation was created regardless of EU directives, though its creation was influenced by the arrangements elsewhere, (2) the period of adaptations to EU and EMU rules, before and after joining EU in 2004 and EMU in 2007<sup>1</sup>.

The proclamation of independence on June 26, 1991 coincided with unresolved disputes over custom duties. Yugoslav federal authorities therefore intervened by an attempt of the army 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 by the assistance of EU diplomacy. In accordance with the ceasefire 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". The above story ended tense and uncertain political and economic developments in the eighties and, definitely so, in 1990. The political future of Slovenia was in 1990 not yet firmly determined 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. This was set on the supposition that Yugoslav economic policy and economic system were inadequate and that the federation was facing political turmoil. What remained unknown was the level of the disintegration, the way in which Yugoslavia would disintegrate, and when this would happen. Therefore, the government had to pursue an economic policy aimed at achieving three major goals: survival of the economy in the period of transition, gradual takeover of economic policy tools from the federal government, and construction of a market-oriented economic system<sup>2</sup>. Pragmatism and gradualism were the pillars of the policy; they should ascertain

socially bearable costs of transition, generate proper responses to economic policies of the federal government, and facilitate rapid adaptation to highly uncertain political decisions.

Though the disintegration of Yugoslavia remains overshadowed by political and ethnic considerations, the prospects of transition and accession to Europe were among the major arguments for Slovenia's secession<sup>3</sup>. Being part of Yugoslavia, Slovenia shared its advantages and disadvantages compared to other socialist countries in Central and Eastern Europe, particularly a rather specific economic and political system based on the ideas of social property and self-management. Due to never ending reforms in Yugoslavia many of the essentials for successful transition were, at least partly, met before 1989; people could travel abroad without any restrictions, enterprises were autonomous, basic market institutions existed, and the system of macro governance enabled use of many standard economic policy tools. Slovenia had also some additional specific advantages; it was the richest part of Central and Eastern Europe, with ethnically and socially homogeneous population, diversified manufacturing sector, predominantly private agriculture, partly privately owned service sector, well established economic links with western markets, and geographic position. Furthermore, Slovenia was not fully integrated into Yugoslavia; it was very autonomous in infrastructure (access to the sea, pipelines, railways, communications, electricity transmission, etc.), and trade patterns with the rest of Yugoslavia resembled trade patterns with the rest of the world. Transition in Slovenia has been considered extremely gradualist<sup>4</sup>. Indeed, gradualism was a kind of a natural heritage of previous systemic changes, entrenched in initial economic conditions, and consistent with soft political changes.

Slovenia has been often considered "a success story" of transition. 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 could afford to implement macroeconomic stabilization

cautiously with pragmatism and risk aversion while refusing patronage of international financial institutions and foreign advisers.

Slovenia was also the first former socialist country entering euro area on January 1<sup>st</sup>, 2007. This ended a rather short period of possessing its own currency - Slovenian Tolar, one of the symbols of her sovereignty. Indeed, one could claim that Slovenia was created as an economic entity on October 8, 1991, when Tolar was introduced, and that the country turned to a province of EU when Tolar was replaced by Euro.

## **2.2. A Short journey from Tolar to Euro**

Four periods can be distinguished in a brief economic history of the country: a short period of transitional depression was followed by a period of balanced economic and social development between 1993 and 2004. 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.

Transitional depression: 1991-1993 Slovenian economy was despite preconditions and thorough preparations for independence badly hit by the secession itself and, even more so, by the subsequent political and economic developments in the remnants of the former federation. The "supply shock" added considerably to inflationary pressures in the first months following independence<sup>5</sup>. The necessity of rapid restructuring was produced more by the secession and ensuing collapse of Yugoslavia than by transition itself. The secession pushed production to a decline of 9.3 percent in 1991 and 6.0 percent in 1992. Employment went hand in hand with the decrease of economic activity; total employment fell by 5.6 percent in 1992, and by 3.5 percent in 1993; the number of unemployed nearly quadrupled in three years, total unemployment reached 137 thousands in the last quarter of 1993, the number of pensioners doubled in the same period to 408 thousands. Both demanded social transfers. Share of public sector in GDP increased to 48 percent. The resulting increases of

the costs of production were transferred to prices which resulted in inflationary pressures, losses, and bankruptcies.

The "boring" period: 1994-2004: In 1993, Slovenia reached the bottom of transitional depression. GDP increased slightly, and turned to growth of 5.3 percent in 1994. After three 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 construction of a "normal" economic system. Foreign demand increased as well<sup>6</sup>. The period of transitional depression turned to a "boring" period 1994-2004 with satisfactory economic performance. GDP grew at more or less constant rate of 4 percent annually, inflation was gradually lowered to a "normal" level, budget was nearly balanced, public debt amounted to 30 percent of GDP only, surplus in services outweighed deficit in trade of goods, and foreign exchange reserves more than matched foreign debt. Social cohesion was retained. The growth prospects however remained uncertain; the tiny economy could not rely on a small domestic absorption; it depended crucially on exports, i.e. on the development of the European economy<sup>7</sup>.

Monetary policy was crucial for preserving 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. Monetary policy was highly restrictive in the first half of 1992; real money supply between October 1991 and June 1992, decreased by 40% and foreign exchange transactions became the only channel of money creation; the ratio of foreign exchange reserves of the BS and high powered money increased from 0.04 to 1.70, and the ratio of total reserves and M1 from 0.31 to 1.35. The regulation of money supply and banks' liquidity shifted from the manipulation of required reserves to open market operations and prudential regulations. 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. Indeed, shortage of foreign exchange which used to be the "normal" state and the binding constraint to economic growth in former Yugoslavia and among major uncertainties before the independence turned to an



excess supply already in 1994. 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 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 19<sup>th</sup> century and the ultimate goal of all former socialist countries in Central and Eastern Europe, Slovenia included; full membership in EU was considered a panacea for all current and future economic and political problems<sup>8</sup>. Enthusiasm for accession was founded both on political and economic considerations. Political democracy and social market model with high standards of living were understandably attractive, and EU was practically the only market left to CEE countries; they also expected capital in a form of direct investments, well paid jobs, and fiscal transfers. CEE countries therefore swiftly adapted their economic policies to reach the goal. For Slovenia, a new “emergency exit” similar to those in 1918 and 1991 appeared with a delay but continued rather smoothly. In the process of accepting EU “aquis”, Slovenia was gradually losing control of the economy. By entering EU in May 2004 and ERM2 in July 2004, Slovenia 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 (see Graph 1).

In 1999, Slovenia began preparations for joining EU and EMU which required drastic changes in economic policies, particularly opening the capital market. When entering EU in 2004, Slovenia already fulfilled four Maastricht criteria and immediately assumed ERM2 status. In a communiqué of June 27, 2004, the central rate of the Slovenian Tolar was set at 1 Euro = 239,640 Tolars and standard fluctuation band of plus or minus 15 percent. The Bank of Slovenia Act was adjusted to the provisions of the Treaty. 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 exactly scheduled; Bank of Slovenia started the preparations for the Euro changeover well ahead of the actual changeover date forming a special Euro Cash Project team. The changeover on January 1, 2007 was smooth, Tolar

remained a legal tender until January 14, it could be converted free of charge until March 1, deadline for exchange of Tolar coins by BS was set to December 31, 2016 and for Tolar banknotes unlimited.

Slovenia's experience during the euro area entry serves almost as a textbook example of possible outcomes though it is impossible to disentangle the effects of the entry from the effects of other developments. 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 oil and agricultural product prices. Previous constant growth in the Slovenian share of exports in EU exports disappeared and turned to stagnation of the share which can be a consequence of the disappearance of exchange rate policy. Unprecedented increase of current account deficit which followed the entry can also be explained by too high growth of GDP. Indeed, it is impossible to say whether Slovenia would be better off with the Tolar; in a very small currency area Euro would anyhow usurp many functions of a legal tender.

The "gambling" period. After entering EU and ERM2 Slovenia relaxed and replaced "old fashioned" conservative or "physiocratic" philosophy by "modern" philosophy, by which wealth can be most efficiently created by »financial deepening«, looking for »opportunities« for acquisitions, and buying securities at home and abroad (see Graph 2). GDP growth strengthened to 7 percent per year due to 15 percent growth in construction and financial services; savings turned to speculations in "highly profitable" investment and pension funds. 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.

### **2.3. 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 still considered a viable political solution; 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. 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. 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; the 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" which was less risky and would not expose Slovenian banks to the likely furious 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. Uncertainty is even better seen by "Slovenian ECU", a measure of account to which the parties in economic transactions could adhere, which was introduced in May 1991, less than two months before the proclamation of independence. Its value was to be determined by the average weekly price of the "certificate" on Ljubljana stock exchange. Slovenia, thus, indirectly established a currency area with floating exchange rate regime within the Yugoslav fixed exchange rate regime.

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; 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.

Exchange rate regime and ensuing macroeconomic stabilization pattern of the new currency were, beside privatization<sup>9</sup>, fields of heated controversies. The government document "P2"<sup>10</sup> of April 15, 1991, handling macroeconomic issues of independence, contemplated most of the settings that were later applied: a rapid conversion (3 to 5 days) of Dinars to a new currency, a 1:1 conversion rate, and floating<sup>11</sup>. This did not prevent alternative ideas. 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 to be part of the package of measures for independence. It was believed that a new country should start as a genuine market economy. 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<sup>12</sup>. The debates on the proper exchange rate regime continued

encompassing major theoretical quandaries known from the debates on the optimum currency area. Two issues; the relationship between real exchange rate and macroeconomic stability, and the anchoring role of nominal exchange rate, divided the participants and the theoretical pros and cons were used to defend different positions. The "pegging versus floating" issue also reflected two opposite general approaches to transition in Slovenia: a radical and a gradualist. The former suggested a formal "shock therapy" macroeconomic stabilization program, the latter suggested that economic policy remains funded on a gradual construction of market institutions and separation of 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 were firm but flexible wage policy, 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.

The linkage between monetary and exchange rate system was, ultimately defined by The Foreign Exchange Act and by Bank of Slovenia Act. They instituted independence of monetary authorities and supply of money as an exogenous variable determined by the central bank. The exchange rate would consequently be endogenous. Slovenia thus established a system of managed floating exercised mainly by developed market

economies. The experiences which followed proved that managed floating was the right choice.

The Bank of Slovenia was established as the central bank<sup>13</sup> within the framework of the legislation promulgated on 25 June, 1991, when the Bank of Slovenia Act (BS) was adopted as one of the most important systemic laws, 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<sup>14</sup>.

The main responsibilities of the BS were traditional: to maintain 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 this task, the BS regulated money supply, regulated liquidity of banks and savings banks, ensured 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 certain financial services for the Republic of Slovenia<sup>15</sup>. 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.

The Slovenian banking system is one of the smallest in the euro area. At the end of 2012, total assets amounted to EUR 46 billion which is equivalent to 139% of GDP and the third lowest figure in the euro area; it has had the highest proportion of government ownership. The banking system comprised 17 banks, three branches of foreign banks and three savings banks.

The Banks and Savings Banks Act, passed on June 7, 1991 and published in the first Official Gazette on June 27, 1991, was short, clear and very precise without any references to EC directives and regulations. Three major issues crucially influenced creation of Slovenian

financial regulation: (1) introduction of managed floating exchange rate regime, (2) privatization, and (3) rehabilitation of the banking system, discussed in a chapter on crisis management. They were all compatible with gradualism as a generally accepted ideology of transition<sup>16</sup>.

### **3. Authentic post independence regulation, 1991-1998**

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. In fact, many provisions of Basel I were encompassed in the regulation though Bank of Slovenia was not a member of BIS. The elements of the regulation are presented bellow.

#### **3.1. Liberalisation of capital movements**

Liberalization and restrictions of capital flows were closely related to managed floating regime introduced at the creation of the country; the major reason for the restrictions of capital flows was prevention of real appreciation of the Tolar. Base money was created through foreign exchange transactions and excess supply was sterilized by Tolar bill transactions. This implied rather unique regulation of supply and demand in foreign exchange market characterized by steady over-supply of foreign exchange. BS therefore additionally regulated supply and demand for foreign currencies by mandatory reserves of foreign exchange (foreign exchange minimum), by obliging banks to balance their foreign exchange assets with foreign exchange liabilities, and by non-interest-bearing Tolar deposit requirements on drawdown under non-trade related loans taken abroad.

Current account transactions were free, so were also transactions related to foreign direct investments: foreigners were allowed to invest into almost any industry. This is 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 monetary 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 of at least seven years being exempted.

### **3.2. Cross-border competition and permitted activities**

The provisions of the Banks and Savings Banks Act, 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. Foreign bank could establish a branch as a legal person, business unit or representative office; foreign bank needed permission by BS, business unit needed consent by BS (article 7). Contrary to other CEE countries, there was no real demand for establishing a bank in Slovenia which can be explained by reforms of the banking system in Yugoslavia, according to which banks were functioning as banks elsewhere, they had well defined "owners" (non-financial corporations), and uncertainty linked to rehabilitation of the banking system between 1993 and 1997 (discussed below).

### **3.3. Capital adequacy**

The provisions which determined or can be indirectly related to capital adequacy for banks and savings banks were set in the Banks and Savings Banks Act of 1991 as follows:

- (1) Banks should operate according to the principles of liquidity, safety and profitability (article 4)
- (2) The capital for establishment of a bank must be at least 35 million dinars (tolars) in cash. To keep the real value the minimum amount of capital in the form of cash would be determined by Bank of Slovenia (BS) (article 9).
- (3) BS determines the conditions for the operation of a bank and issues an unlimited or a limited operating license. The limited permission access to certain banking businesses can be granted by the BS which also determines conditions.
- (4) To secure its obligations to its 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). Guarantee capital comprises of: initial paid-up capital, reserves, and other forms of start-up capital and other resources to fully cover bank business risks and losses of the bank. A more detailed definition of the different forms of guarantee capital were to be set by BS (article 23).

- (5) 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).
- (6) The bank's investments in land, buildings, business equipment holdings in other banks and non-banking organizations must not exceed the regulatory capital of the bank. Investments in land, buildings and holdings in non-banking organizations, the bank obtained on the basis of realizing arrears shall 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 must make provisions against potential losses arising from risky investments and related off-balance sheet items. The amount and manner of provisions is set by BS, depending on the rate of risk assets and off balance sheet items (article 29)
- (7) Banks, savings banks and savings co-operatives are obliged to operate so as to maintain their solvency; the detailed criteria for maintenance of liquidity are set by BS (article 38).
- (8) Banks are obliged to have minimum reserve holdings with BS. The requirements are applied against Tolar deposits, loans received, and bank securities held by non-banks. These requirements were changing. Minimum reserve requirements at end of 1997 were, for example, 12% for sight deposits and time deposits with maturity of up to 30 days, 6% for deposits with maturity between 31 days and three months, 2% for deposits with maturity between three and up to six months and 1% for deposits with maturity between six months and up to one year. The average calculated reserves

ratio on Tolar deposits at the end of 1996 amounted to 6.4% (against 6.7% in 1995).

The obligatory reserves were remunerated at a symbolic interest rate of 1% p.a.

In 1993, BS decided that from December 1993 banks should use the methodology of the Committee on Banking Regulations and Supervisory Practices in Basel (Basel I). From August 1<sup>st</sup>, 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 of balance sheet assets and off-balance sheet items and the establishment of provisions for credit risk. Changes in classification of assets and off-balance sheet items were mainly in lowering percentages used for calculating potential losses on receivables classified in the individual rating categories and, at the same time, tightening the criteria for classification. An important new feature was optional carrying provisioning for potential losses.

### **3.4. Large exposures**

According to Banks and Savings Banks Act banks had to comply with the provisions on the large and maximum loan to one borrower, the provisions on the total amount of all loans, other receivables and guarantees to a single borrower and terms of the total amount of large and maximum loans (article 26). A large loan was considered an individual loan or other individual claim and guarantee given to one borrower in excess of 10% of the regulatory capital, while maximum loan to one borrower was a loan which was 15% of the regulatory capital. The total amount of loans, other receivables and guarantees to a single borrower might not exceed 30% of the regulatory capital of the bank. The total amount of all the major and largest possible loans might not exceed the regulatory capital of the bank.

### **3.5. Supervision on a consolidated basis**

Banks and Savings Banks Act defined banking group, if one bank is directly or indirectly involved in the founding capital of another bank with a minimum of 40% of the shares or, if it is managed directly or indirectly by another bank. The bank, which owns part of the capital of another bank, must use the consolidated financial statements in the manner and within the time limits prescribed by BS (article 21). The bank which owns the equity of other

banks should consolidate the capital in the manner and within the time limits prescribed by BS (article 23).

### **3.6. Deposit Guarantee Scheme**

According to the provisions on the deposit guarantee in the Banks and Savings Banks Act, a bank, which collects deposits must insure them with an institution authorized to insure deposits; a bank which does not insure deposits may no longer conduct business with savings deposits. Notwithstanding that, the bank must secure deposits up to the amount prescribed by the Ministry of finance with the Agency of the Republic of Slovenia to insure deposits in banks and savings banks which 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.

### **3.7. Crisis Management**

Pre-rehabilitation, Recovery, Bankruptcy and Liquidation of Banks and Savings Banks Act (Official Gazette 1/1991) provided solutions for handling of crisis in the banking system. The Act introduced four types of measures in cases of crisis in the banking system. Pre-rehabilitation measures in a bank or savings bank can be imposed if BS establishes non-fulfillment of measures which could endanger security of the banking system; the recovery process may be established if loss or potential loss items represent more than 50% of the regulatory capital of the bank; bankruptcy proceedings is introduced if BS establishes that recovery is not economically justified, while liquidation procedure is introduced if the founders decide on the dissolution or if BS reveals that the bank no longer fulfills the conditions for functioning.

Pre-rehabilitation measures can be introduced in banks and savings banks if BS establishes: insolvency, violation of multipliers by 20% in the last six months, potential loss arising from risky investments and off-balance sheet asset items for more 30% of the regulatory capital; non-fulfillment of other prescribed conditions, operations and monetary policy measures, which could endanger the security of deposits of citizens. BS determines potential losses on the basis of hazard classification of assets and off-balance sheet items. Governor of BS can prescribe deadlines to remedy the situation; designate the person who will monitor the operations; monitor the use of funds from the guarantees for bank deposits; examine the costs and payments to the bank accounts; check or suggests payment orders for outstanding liabilities; review, approve or prohibit the granting of overdraft, prohibit the sharing and distribution of profits; prohibit the granting of new loans, guarantees and letters of credit.

The proposal for the introduction of the recovery procedure can be made by the bank founders, creditors, banks and authorized organization for payment transactions. The Governor of BS issues an order establishing a procedure for assessing the financial position and economic viability of its rehabilitation. Economic viability of the rehabilitation depends on the amount of losses and potential losses; an amount which, in the case of bankruptcy would be the burden of the state, BS, and the Agency for Insurance of Deposits in banks and savings banks; indicative amount of funds needed for recovery; offers from other banks to enter the bank, the conditions under which other banks would take over the bank and assume the consequences of their financial situation; willingness of other entities for the purchase of the bank; economic impact of recovery. The Governor of BS issues a final decision on the introduction of the recovery procedure. Recovery of the bank is carried out by: additional capital, partial or full waivers by the bank; temporary or permanent acquisition of potential losses, together with the relevant part of the liabilities; taking over of the bank by other banks, new shares taking into account the creditworthiness of the buyer; additional payments of capital into the bank. The government would designate the organization (agency) which takes over the procedure, while funds needed would be provided by the budget. The recovery agency would purchase losses or potential losses,

assume potential losses, together with the relevant part of the liabilities; manage purchased and potential losses together with the corresponding part of the liabilities; sell permanently acquired potential losses, give loans to banks, which took over the bank in recovery; buy shares in the recovered bank, organize the sale of the shares and acquisition of the bank by other banks. Funds generated by the recovery should go to the state.

If the recovery procedure fails, BS can begin bankruptcy proceedings. In case of bankruptcy proceeding governor of BS issues a decision establishing the conditions for the opening of insolvency proceedings against the bank. The existence of conditions may also be suggested by creditors, founders and authorized organization for payment transactions. The bank may complain to the Board of BS which makes final decision which can be challenged at the competent court. Creditors' claims are paid from the bankruptcy estate in the following order: receivable from bank deposits guaranteed by the Republic of Slovenia, the BS and the Agency for Insurance of Deposits; claims of the Bank of Slovenia; claims of creditors who do not own the bank; claims of the bank's owners.

Decision establishing the conditions for the liquidation procedure is issued by the governor of the BS if bank no longer fulfills the conditions for further work, or by the decision of the founders of the bank. Other bank would take over the operations of the bank in liquidation; assets that remain after liquidation proceedings shall be divided among the owners of the bank.

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). With the creation of an independent state the potential need to bail out some banks appeared. Therefore, BS made rough analysis of the costs of such intervention, which showed a lot of problems in the banking system. The greatest burdens were: bad loans, whose volume after Slovenia's independence increased since debtors were also in the other countries of the former Yugoslavia, foreign currency deposits of population which were with the former National Bank of Yugoslavia, thus with the debtor remaining outside the jurisdiction of the Republic

of Slovenia, and excessive operating costs of banks mainly due to excessive number of bank employees and irrationally organized networks.

The capital adequacy was the basic criterion in the assessment of the extent of recovery needed. According to it, two largest banks were technically insolvent. During the beginning of their recovery, the BS introduced pre-rehabilitation measures, which were to prepare everything necessary for commencement of recovery proceedings on the basis of the appropriate act, the related implementing regulations, and government decree on the establishment of the Agency for the Rehabilitation of Banks (Official Gazette, 10/08/1991; 1/8/1992, 10/8/1993). BS, which was the initiator of recovery procedures, together with the Agency opted for a gradual introduction of the procedures in individual banks to the extent and dynamics defined by the current situation of individual banks, available frameworks of public debt provided for that purpose, and the monetary framework of the state budget for servicing the debt. A decision to initiate the process was based on an assessment of the financial situation of the bank. The chosen procedure was partly a revised method used in some other countries: writing off current losses against capital, replacing bad bank assets with bonds guaranteed by RS, transferring of assets to liabilities in the form of subordinated debt of the former owners, recapitalization, and transfer of ownership to the Agency. By the decision of BS, leadership, management and supervisory bodies were dismissed and the rights of existing shareholders (founders), which were partly used to write off the losses of banks and partially transmitted to the Agency as subordinated claims of shareholders to the Agency. Such a recovery procedure implied (at least temporary) nationalization. The Agency appointed the management of the two banks which was responsible and accountable for the operational implementation of recovery. 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. Because of structural imbalances, a high proportion of long-term government securities with foreign currency clause in the total assets of the bank, the banks became sensitive to foreign currency and interest rate risks. Operations of banks under recovery however already in 1993 showed the first positive

results in the balance sheet and profit and loss account, in balancing cash flow, and in reducing borrowing from the BS. The two banks were gradually able to comply with most of prudential rules (adequate liquidity, large exposure, etc.) imposed on them by BS. Their cash-flow and liquidity improved significantly during 1996; they were actually able to manage their own liquidity during the second half of 1996 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 operations of LB d.d and KBM d.d. By it, the credits and liabilities of the former federal institutions, as well as obligations to final beneficiaries of loans from other republics were retained by LB d.d. and KBM d.d. Legal situations in new states on the territory of former Yugoslavia differed due to different actions of their governments in the period of the collapse of Yugoslavia and different status of depositors of LB d.d. The issue has remained unresolved and the rather shortsighted decision has become the subject of law suits in domestic and international courts.

### **3.8. Accounting**

Economic and financial audit of the accounts of banks for the year 1990 was made in the banks domiciled in the Republic of Slovenia on the basis of the decision by the government (Executive Council) of the Republic of Slovenia. The BS produced guidance on the data and information provided by banks to prepare the accounts. The guidance was based on the methodology prepared by the National Bank of Yugoslavia in cooperation with foreign consultants to audit the annual accounts of banks in 1989. In 1993, BS requested the implementation of the Slovenian Accounting Standards and provided a new chart of

accounts for banks and savings banks, which, together with the accounting standards came into force in 1994. Indeed, the main goal of BS was harmonization of accounting regulations with international standards, which should also provide the basis for better supervision.

### **3.9. Supervision of banks and savings banks**

Control over the operations of banks and savings banks by BS was to be in accordance with the provisions of the Banks and Savings Banks Act and Bank of Slovenia Act. Control encompassed indirect control (review of reports and other documents that it receives from the banks and review of data and available other documentation) and direct inspection of the books and other documents. In 1993, BS tightened control over the operations of banks and savings banks, as the checks identified irregularities and shortcomings, especially in the newly created savings banks. One of important activities of the BS in the context of supervision was issuance of permits and approvals such as business licenses, extension of business activities, establishment of representative of a foreign bank, consensus that a single shareholder can have more than 15% shares, approvals for appointment of the director etc.

### **3.10. Indexation and de-indexation**

Indexation was inherited from Yugoslavia and used from the very creation of the new country to cope with some consequences of extremely high inflation. Immediate price stability was not the major concern of BS. Indeed, BS pursued a policy of gradual reduction of inflation and stability of real exchange rate of domestic currency; gradual lowering of inflation was mainly a consequence of increased competition from abroad due to opening of the country and reduction of custom duties. High inflation required high initial nominal interest rates. Real interest rates were defined as the real component above the indexation rate (Base Rate - BR, in Slovenian TOM) which was determined by inflation rate in the three months period. The BS was reducing base rates gradually and in line with declining inflation and by de-indexation of its monetary instruments. Measures towards de-indexation were first used in 1995, when 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. These contributed to a reduction in 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. Later, the reference period for calculation of BR was extended to 12 months. In September 1998, BS issued a parallel 270-day 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. The government treasury followed the example and issued the bonds at a nominal interest rate.

### **3.11. Foreign exchange market**

Foreign exchange shortages used to be a kind of "economic law" 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. Due to the termination of National Bank of Yugoslavia (NBJ) interventions in the foreign exchange market and overvalued Dinar exchange rate at the beginning of 1991, Slovenia had to adopt (March 1991) a special regulation to payments abroad; exporters had to sell 30% of foreign exchange earned to BS for the so called common needs at the daily exchange rate, while the rest could be used for payment of its own imports or sold in the form of import rights to other importer or to the banks. When establishing the initial exchange rate 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 initial rate was set to stimulate exports; new currency exchange rate of 1 DM = 32 Tolars was more than 10% higher than market rate. A sufficiently high rate combined with restrictive monetary policy led to highly positive current account balance, and Slovenia soon faced abundance rather than shortage of foreign exchange. Actual development thus enabled very quick elimination of mandatory sale of foreign exchange to BS, of the obligation to use it for own payment or of selling it in 72 hours. BS continued to perform payment transactions for users which were financed from the budget with the purchase of foreign exchange in the market at freely determined exchange rate. The BS regulation

remained cautious regarding liquidity of banks in foreign exchange. Thus, banks were required to hold reserves in foreign exchange in form of liquid assets on accounts with first-class foreign banks to ensure liquidity of payments and to fulfill their obligations to holders of deposits in foreign exchange, both of domestic and foreign persons (foreign exchange minimum). The monthly obligatory foreign exchange minimum was determined in dependence of the volume of payment transactions with foreign countries (35% of the last three months average), the volume of household deposits in foreign exchange (100% of sight deposits, 75% of deposits with maturity up to 3 months, 35% of deposits with maturity between three and 12 months, 5% of deposits with maturity over one year), on the volume of deposits by non-residents (90% of sight deposits, 75% of deposits with maturity up to three months, 35% of deposits with maturity between 3 and 12 months, 5% of deposits with maturity over one year), and, since February 1996, also on the net sale of foreign cash. Due to amendment adopted in June 1996, banks were obliged to hold at least 30% of their foreign exchange minimum in form of Bank of Slovenia foreign currency denominated bills by the end of 1996.

Banks also had their net daily foreign exchange position (i.e. the difference between foreign exchange assets and liabilities in the country and abroad) prescribed with a minimum of 75% of the monthly foreign exchange minimum. In July 1996, BS adopted the obligation for banks to balance any additional liability to foreign persons beyond their position at July 31, 1996 with corresponding assets. Such liabilities comprise any and all liabilities to foreign persons (in Tolars and in foreign currencies) and liabilities under foreign loans taken by domestic legal persons in which banks hold a majority participation.

The increasing burden of sterilization of foreign exchange inflow forced BS to speed up adoption of complementary legal and regulatory framework. As of June 1995, the regulation on compulsory liquidity reserves in foreign exchange (foreign exchange minimum) also included increasing obligatory holdings of foreign exchange denominated Bank of Slovenia bills. As of August and December respectively, obligatory non-interest bearing deposit of 40% in Tolar counter-value was to be paid on any and all drawings under non-trade related loans taken abroad with maturity up to 7 years, and 10% on those with

maturity over 7 years (in the latter case domestic banks and the Republic of Slovenia are exempt from the obligation). While Foreign Exchange Transactions Act (Official Gazette 1/1991) regulated transactions and possession of foreign exchange by business, banks and households and the role of central bank in managed floating of the currency: BS manipulated this by Regulations of the Governing Board. Thus, for example, to prevent excessive borrowing abroad BS introduced a non-interest bearing deposit on foreign non-trade-related loans in February 1995. The obligation was set at 40% for loans with maturities under seven years and at 10% for loans with maturities beyond 7 years. Exempt from the 10% obligation were domestic authorized banks, the Republic of Slovenia, and the Slovenian Export Agency.

#### **4. Adaptations to and acceptance of EU regulation, 1999-2007**

##### **4.1. Preparations for and entry into EU and EMU**

One of the rationales for the independence was easier access of Slovenia to European associations, EU in particular. Negotiations with EU began already in 1992. They were followed by a conclusion of the Association Agreement in June 1996, which entered in force after its ratification by the parliaments of Slovenia and of the 15 EU member countries. Slovenian Parliament ratified the Association Agreement in July 1997. Before all EU member countries ratified the Association Agreement, the Interim Agreement on trade and trade-related matters was used. Regarding trade, the agreement was targeted towards establishment of a reciprocal asymmetrical free trade zone. 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 and culture, prevention of fraud, etc. The core of financial regulation for the new period was set by a new Banking Act 1999 which was passed assuming that Slovenia will become a member state of EU and EMU. Therefore, the act established distinction between member states of the European Community and other (foreign) countries. A person of a member state was a natural person who domiciled in a member state or a legal person established in the territory of the member state. A foreign

person under this Act, was a physical person residing outside EU or a legal entity which was established outside the territory of the Republic of Slovenia and outside the member states (article 13). Banks may carry out banking and other financial services, for which they were authorized by the BS or in member states, either through a branch or directly, if they met the conditions laid down by the law of the member states.

On July 17<sup>th</sup>, 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. Under the new Act the BS's decision-making powers were vested, as before, in the Governor and the Governing Board, but the latter was reduced from eleven members to nine: the Governor, four Vice-governors and four Members. All are appointed by the National Assembly at the nomination of the President of the Republic for a term of six years with the possibility of reappointment. The Governing Board decides by a two-thirds majority of all its members on all matters that are within its authority under the Bank of Slovenia Act and other legislation. The BS and the members of its decision-making bodies are independent and are not bound by the decisions, views or instructions of government or other institutions in carrying out their tasks, nor may they seek their guidance or direction. The BS's independence was reinforced by the fact that the act required that BS only reports to the National Assembly on its activities; the National Assembly no longer approves the Banks' financial plan and annual accounts. However, until the introduction of the Euro as the monetary unit of the Republic of Slovenia, a committee of the National Assembly appoints an independent external auditor for a three-year period to audit the BS's financial statements.

Entering EU and EMU implied liberalization of capital movements, and would affect rules on credit institutions and investment firms, supervision on a consolidated basis, supervision of financial groups and conglomerates, large exposures, investment services, deposit guarantee schemes, crisis management, cross border competition and permitted activities, capital requirements, and accounting. Indeed, new regulation became extremely cumbersome, which 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.

Slovenia entered the ERM II, one of the prerequisites for introducing Euro, on June 28<sup>th</sup>, 2004. 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  $\pm 15\%$ . On July 11<sup>th</sup>, 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 i.e. SIT 239.64 to the Euro. The final phase of preparations followed in the second half of the year. The actual changeover on New Year's Day 2007 proceeded smoothly. Banks' balance sheets and all customer accounts were converted by the afternoon on January 2<sup>nd</sup>, 2007 as planned, while incorporation into payments proceeded without problems. The BS ceased to independently implement monetary policy at December 31<sup>st</sup>, 2006 and began implementing the single monetary policy of the Euro-system and harmonized its monetary policy instruments with the operational framework of the Euro-system's monetary policy. 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 sectors<sup>17</sup>.

The Banking Act of 1999 nullified the Banks and Savings Banks Act and its amendments (Official Gazette of RS, no. 1/91-I, 28/92 and 46/93), the Rehabilitation, Bankruptcy and Liquidation of Banks and Savings Banks Act (Official Gazette of RS, no. 1/91-I 46/93) the Agency of the Republic of Slovenia for Securing Deposits in Banks and Savings Banks Act (Official Gazette of RS, no. 1/91-I 46/93), the provisions of Articles 13, 14 and 17 to 20 of the Savings and Loan Undertakings Act (Official Gazette of RS, no. 14/90 and 30/90). It also postponed the use of provisions of articles 43 to 46, articles 48 to 51, and articles 53 to 57 of the new act which should enter into force on the day of the full membership of Slovenia in the European Communities. Joining EU implied that directives and regulations of EC should become part of the Slovenian legal system.

#### **4.2. Overview of Financial Regulation between 1999 and the crisis**

The Banking Act of 1999 (Official Gazette of RS No. 7/99) came into effect on February 20, 1999. With the new law, banking legislation introduced all Stage One measures and, to a great extent, Stage Two measures of the EU in this area (aimed at providing the overall legal framework and at addressing fundamental principles and procedures governing the sector). This implies that the banking legislation was fully harmonized with the First Council Directive, the Own Funds Directive, the Solvency Ratio Directive, the Directive on Deposit-Guarantee Schemes (effective as of January 1, 2001), the Directive on Money Laundering and to a big extent the 25 Core Principles for Efficient Banking Supervision adopted by the Basle Committee on Banking Supervision in 1997. The principal novelties introduced were the following:

- Establishment of a bank and definition of financial services in line with EU directives. The law defined taking of deposits from natural and legal persons and giving credits based on such deposits by a bank in its own name and for its own account as banking services in addition to all other services which, pursuant to other laws, are to be provided by banks only. Limited banking licenses were abolished and minimum capital required was set at SIT 1 billion.
- Common standards for banking license.
- In line with the Second Banking Directive the board of management should have at least two members who have demonstrated to be fit, proper and experienced; they would be held accountable for compliance of the bank operation with prudential rules and other stipulations of the law.
- Foreign banks could establish branches in Slovenia subject to the BS's license but were not allowed to provide banking and other financial services directly until Slovenia becomes full member of the EU. The BS may require endowment capital in form of a deposit or other guarantee for settlement of any liabilities of such branch deriving from its operations in Slovenia. Branches of foreign banks shall be subject to supervision of the BS. In the transition period and until Slovenia becomes full member of the EU the stipulations concerning branches of foreign banks shall apply also to banks of EU

member countries. After Slovenia becomes full member of EU, banks licensed for banking operations by the respective home (member) country authorities will be allowed to provide banking services in Slovenia either directly or through branches; their operation in Slovenia will be subject to supervision of the BS.

- The difference in treatment of domestic and of foreign investors acquiring an ownership share in domestic banks was abolished. Under the old law, approval of the BS was necessary for domestic persons acquiring an ownership share exceeding 15% of voting rights, and for foreign persons acquiring any stake (percentage) in a domestic bank. The new law stipulated that approval is needed for acquisition of a qualified participation (meaning direct or indirect holding of 10% of voting rights or of the capital) and for any further acquisition of shares of the same bank if such acquisition results in a 20%, 33% or an ownership share of 50% of voting rights or of the capital and in a controlling position of such investor.

- Prudent and sound operation of banks is to be safeguarded by appropriate capital (in the old law regulatory capital) scaled to the scope and type of operations performed by a bank, and by management of risks in compliance with the law. The minimum capital requirement and the capital adequacy ratio of at least 8% were in line with the capital directives (Council Directive on Own Funds of Credit Institutions, 89/299/EEC) and the Council Directive on Solvency Ratio for Credit Institutions. 89/647/EEC) and remained basically unchanged against the old law.

- Identification, measurement and management of credit risk and provisioning for bad assets were put in line with international rules and standards. New were non-mandatory reserves for general banking risks aimed at cover of any losses resulting from risks deriving from all banking operations.

- The stipulations on large exposure to a single borrower or to a group of related persons, on maximum single exposure (25% of the bank capital) and on maximum large exposure (800% of the bank capital) were put in line with the Large Exposure Directive

(92/191/EEC). The law introduced the definition of related persons and enables supervision of credit institutions on a consolidated basis.

- The stipulations on management of liquidity risk, interest rate risk, currency risk, and other market risks introduced partial implementation of the CAD Directive; in line with the Second Banking Directive they limited investment of banks in equity and in real property.

- Supervision of banks on a consolidated basis enabled supervision of risk management activities of a whole banking group. The new definition of a banking group was broader and comprised other financial intermediaries, financial holdings and companies active in ancillary banking services. One of the features of the banking group is direct or indirect majority ownership participation of at least 20% (against 40% in the old law) of voting rights or capital (controlling stake and prevailing influence). The stipulations on consolidated supervision were put in line with the EU Directive 92/30/EEC on consolidated supervision of credit institutions.

- The new act brought all credit institutions providing banking services under the jurisdiction of the BS. Off-site control and on-site examination were put in line with international supervisory standards. The new law enabled BS to supervise legal persons related to a bank if deemed necessary for thorough supervision of a bank or in case the BS reasonably suspects that such legal persons conduct banking activities without having obtained the BS license.

The BS continued with efforts to ensure the harmonization of Slovenian laws with the EU acquis and the preparation of further negotiating positions with regard to the freedom to provide services, the free movement of capital, Economic and Monetary Union, and institutions. Negotiations on Slovenia's entry to the EU were concluded in December 2002. With regard to free movement of services, a transition period lasting until December 31<sup>st</sup>, 2004 was secured for the application to savings and loan undertakings established before 1999 of the capital and other requirements of safe and sound banking that are the subject of the Second Banking Directive 89/646/EEC and Directives 86/635/EEC, 89/299/EEC,



89/647/ EEC, 92/121/EEC and 94/19/EC. A transitional period until December 31<sup>st</sup>, 2005 was secured for protection of the level and scope of the domestic deposit-guarantee scheme at banks, and the protection of the level and scope of the domestic investor-compensation scheme for the funds of investors with an investment firm. Slovenia adopted the EU acquis for free flow of capital and Economic and Monetary Union. On accession to the EU Slovenia would participate in Economic and Monetary Union, although it would have derogation with regard to the introduction of the euro under the Treaty establishing the European Community. After accession, Slovenia would be required to act in accordance with the ultimate goal of introducing the euro. On Slovenia's accession to the EU the BS would become part of the ESCB and the governor of the BS would become a member of the ECB General Council, while upon the introduction of the euro in Slovenia, the BS would become part of the Eurosystem and the governor of the BS would become a member of the ECB Governing Council.

Slovenia negotiated with the European Union in the field of freedom to provide services covered banking, insurance business, securities market, investment funds and non-financial services. The respective legislation was aligned, to a large extent, with that of the European Union, especially so the banking legislation. Slovenia prepared and delivered its negotiation position on Chapter 3 – Freedom to Provide Services in the second half of 1999, requesting transitional periods (starting on the expected date of EU accession) in the alignment with the EU directives in two cases.

The first request concerned capital adequacy requirement for savings institutions established prior to enforcement of the new Banking Act which stipulated the minimum capital required for savings institutions at SIT 186 million. A transitional period of five years following the enforcement of the new Banking Act and two years following the expected date of EU accession respectively would enable them to fully meet this and other requirements related to risk management and safe and prudent management of operations. The second request concerned the deposit insurance scheme. Slovenia requested a transitional period of three years after the expected date of EU accession. The new Banking Act namely introduced a new deposit guarantee scheme in line with the

European directive by abolishing the guarantee of the Republic of Slovenia and by limiting the deposit guarantee to SIT 3.7 million per depositor. It also introduced deposit guarantee for legal persons, i.e. enterprises of a certain size.

The third Banking Act 2006 (Official Gazette of RS, no. 131/06) was passed when Slovenia was in the ERM2 regime and preparations to enter EMU on January 1<sup>st</sup>, 2007. The major reason for the adoption of the new Banking Act, which came into force on January 1, 2007, was to comply with Directive 2006/48/EC and Directive 2006/49/EC. These directives brought new significantly more complex standards, the so-called Basel II. Transfer arrangement in the act called for extensive changes in key areas of regulation of the banks, particularly in risk management and control, which would be an important supplement, or amending legislation in almost all chapters of the previous act. It was therefore more efficient and transparent, that, instead of a change in the Banking Act, this was done with the new act (BAN -1).

The BAN-1 transposed the following directives of the European Parliament and of the Council :

- Directive 2006/48/EC of the European Parliament and of the Council of June 14, 2006 relating to the taking up and pursuit of the business of credit institutions;
- Directive 2006/49/EC of the European Parliament and of the Council of June 14, 2006 on the capital adequacy of investment firms and credit institutions;
- Council Directive 86/635/EEC of December 8, 1986 on the annual accounts and consolidated accounts of banks and other financial institutions, as last amended by Directive 2003/51/EC of the European Parliament and of the Council of June 18, 2003 amending Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings;
- Directive 94/19/EC of the European Parliament and of the Council of May 30, 1994 on deposit-guarantee schemes;

- Directive 2000/46/EC of the European Parliament and of the Council of September 18, 2000 on the taking up, pursuit of and prudential supervision of the business of electronic money institutions of money laundering;
- Directive 2001/24/EC of the European Parliament and of the Council of April 4, 2001 on the reorganization and winding up of credit institutions;
- Council Directive 89/117/EEC of February 13, 1989 on the obligations of branches established in a Member State of credit institutions and financial institutions having their head offices outside that Member State regarding the publication of annual accounts.

The most important principles of the BAN - 1 and the main solutions through which those principles are to be implemented were:

- principle of a safe, caring and transparent operations of banks, requiring banks to take appropriate measures to effectively manage the risks to which they are or might be exposed in their operations. This principle is to be realized, in particular, through the rules laid down in the 4th chapter of the BAN -1. The most important among them are: the request that a bank sets up a reliable and robust system management, the capital adequacy requirement, the requirement that a bank establishes appropriate strategies and processes for assessing internal capital, the requirement that a bank operates in accordance with the limits for exposure and other constraints, and the requirement for adequate liquidity management.
- principle of prudential bank is implemented through rules on the corporate structure of a bank (section 2 of the BAN -1), in particular through the rules of the Management Board and the holders of qualifying holdings. To ensure transparency of the bank additional rules on the publication of annual reports and other disclosures about the bank's operations were specified in 5 chapter of the BAN -1.
- principle of effective banking operations which requires and enables banks to apply rules on risk management exercise in proportion to the character, extent and complexity of the transactions that they perform. The new rules on capital requirements were set out in the fourth chapter of the BAN - 1, dealing, in particular, with the use of approaches based on

internal rating systems or other own designs tailored to business and individual bank risk, and adequate consideration of measures limiting the risks (credit insurance) and dispersion of credit risk (securitization).

- principle of prudent and effective controls which requires that supervision over the banks is provided by appropriate supervisory authority to which the law gives the possibility to impose control measures which can effectively achieve the purpose of monitoring which would ensure that banks operate in accordance with the rules of risk management and other prudential rules of business conduct. This principle is realized through control rules (on an individual and consolidated basis) set in the 7th chapter of the BAN -1.

- principle of investor confidence which is realized in particular through: the rules of security for the applications specified in chapter 8 of the BAN -1 and the rules of confidentiality set out in 6th chapter of the BAN -1.

The entry to EU required changes in other acts regulating financial sector, as well. The newly passed acts therefore began with explicit acceptance of EU Directives. Thus, Financial Conglomerates Act (Official Gazette of RS, no. 43/06) explicitly included the following directives: Directive 2002/87/EC on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate amended by Directive 2010/78/EU, 98/26/EC, 2002/87/EC, 2003/6/EC, 2003/41/EC, 2003/71/EC, 2004/39/EC, 2004/109/EC, 2005/60/ EC, 2006/48/EC, 2006/49/EC and 2009/65/EC on European Banking Authority, the European Insurance and Occupational Pensions Authority, and European Securities and Markets Authority. The act was implemented by BS regulations on: (1) the rules for calculating the supplementary capital adequacy requirements of the regulated entities and for calculating adjusted capital requirements of uncontrolled entities in a financial conglomerate (Official Gazette of RS, no. 8/07), (2) the rules on significant concentrations of risks regulated entities in a financial conglomerate (Official Gazette of RS, no. 32/07), (3) the rules on significant transactions of regulated entities in a financial conglomerate (Official Gazette of RS, no. 36/07), (4) the rules on the Register of financial conglomerates (Official Gazette of RS, no. 45/07).

The directives which were explicitly accepted in the Instruments of Financial Market Act (Official Gazette 67/2007) were: Directive 89/117/EEC on the obligations of branches established in a member state and financial institutions headquartered outside member states regarding publication of annual accounts; Directive 97/9/EC on investor-compensation schemes; Directive 98/26/EC on settlement finality in payment and securities settlement systems; Directive 2001/34/EC on the admission of securities to stock exchange listing and on information on securities; Directive 2003/6/EC on insider dealing and market manipulation (market abuse); Directive 2003/71/EC on the prospectus to be published when securities are offered or admitted to trading; Directive 2003/124/EC on definition and public disclosure of inside information and definition of market manipulation; Directive 2003/125/EC on fair presentation of investment recommendations and disclosure of conflicts of interest; Directive 2004/39/EC on markets in financial instruments; Directive 2004/72/EC on accepted market practices, inside information, the list of persons with access to inside information, managers' transactions and suspicious transactions; Directive 2004/109/EC on the harmonization of transparency requirements to information on issuers whose securities are admitted to trading on a regulated market; Directive 2006/48/EC on the taking up and pursuit of the business of credit institutions; Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions; Regulation (EC) no. 2273/2003 on exemptions for buy-back programs and stabilization of financial instruments; Regulation (EC) no. 809/2004 on prospectuses.

The most comprehensive and substantially important were two directives: Directive 2006/48/EC and Directive 2006/49/EC. Namely, the banking act valid before January 01, 2007 was already adjusted to most other directives. Let us therefore look more precisely the implementation of these two directives in the new Banking Act, known as BAN – 1.

Articles 108 to 123 of BAN -1 include definitions of risk management which are needed to comply with the definitions of those terms in Article 4 of Directive 2006/48/EC or the relevant sections of Article 3 of Directive 2006/49/EC. Article 124 is a nearly verbatim transcript of Article 22 of Directive 2006/48/EC. Capital adequacy requirements relating to

the so-called regulatory capital, which are in section 4.5., deal with three types of risks: credit risk, risks that belong to market risk, and operational risk.

Capital requirements for operational risk were novelty brought by Directive 2006/48/EC; operational risk is a significant risk faced by credit institutions and requires coverage with own funds. The own funds can serve to absorb losses which are not matched by sufficient profits to ensure the continuity of institutions and to protect investors. Own funds also serve as an important yardstick for the competent authorities, particularly in assessing the solvency of institutions and for other prudential purposes. It was considered that it is appropriate to lay down common basic standards for own funds which would strengthen financial system and prevent market distortions. Thus, in addition to the regulatory capital requirements the bank must also meet the requirements of the so-called internal capital. Article 127 of BAN-1 implements Article 123 of Directive 2006/48/EC which requests that the bank must operate in such a way that the risks to which it is exposed in transactions do not exceed the maximum permissible exposure limit or the sum of exposure limits of investments in qualifying holdings outside the financial sector, or other restrictions established by the act and the regulations on risk management. The content of risk management in respect of which the BS should adopt implementing regulations is determined in Article 129. The arrangements in Articles 130 and 131 transfer rules of Articles 68, 71 and 72 of Directive 2006/48/EC. The term "bank capital" in the BAN-1 is used in a specific sense. The first paragraph of Article 132 states that the capital of the bank, which determines whether the bank complies with the obligations regarding the management of the risks, is calculated according to the specific rules set out in Section 4.4. and other regulations on risk management. Bank capital is composed of basic Tier 1 (Article 133) capital and additional - Tier I and Tier II (Article 134) capital.

Article 135 of the BAN-1 transposes Article 74 (1) of Directive 2006/48/EC, according to which the bank must apply the rules on the valuation of the items on the basis of Regulation No 1606/2002 and Directive 86/635/EEC (specific rules on annual and consolidated reports of banks and other financial institutions). The basic rules for the valuation of accounting

items are set out in the first paragraph of Article 67 of the Companies Act, the Slovenian Accounting Standards, and International Financial Reporting Standards.

Article 136 of the BAN-1 transposes Article 75 of Directive 2006/48/EC, according to which the minimum capital must always be at least equal to the sum of the capital requirements for individual types of risks to which the bank is exposed. Capital requirements for individual types of risks are in detail set in subsequent subsections of the BAN-1; the capital requirement for credit risk is set to 8 percent of the total risk-weighted exposure (Article 137 of the BAN-1). The new regime is significantly different from the previous arrangements in the approaches to calculating risk-weighted exposure, and in due consideration of collateral and securitization in the calculation of capital requirements for credit risk. According to Article 138 of the BAN-1, a bank may for calculating risk-weighted exposure amounts choose among: standardized approach or the approach based on internal ratings systems. For the use of the internal ratings-based systems, the bank must meet certain requirements and obtain authorization from the BS.

In subsection 4.5.3 BAN-1 sets out the rules on the calculation of capital requirements for each type of market risk. The concept of market risk in the BAN-1 is used for: position risk, settlement risk, counterparty credit risk, risk of exceeding the maximum allowable exposures in the trading book, foreign currency risk, and risk of changes in commodity prices. For each of these risks the capital requirement is calculated. Therefore, Articles 147 and 148 define the institution of the trading book, while in Article 149 there are certain specific rules on the valuation of the trading book and for the calculation of net positions. Article 150 lays down general rules for calculating capital requirements for position risk, while Articles 151 or 152 set out special rules for calculating capital requirements for position risk of debt and equities. Article 153 regulates calculating capital requirement for settlement risk, Article 154 regulates calculating capital requirements for counterparty credit risk, Article 155 regulates calculating capital requirement for foreign exchange risk, and Article 156 regulates calculating capital requirement for commodity risk. According to Article 157, a bank may for the calculation of certain types of capital requirements for market risk use internal models; if so, the internal model must obtain authorization from

the BS. Article 158 regulates the manner of calculating capital requirement for the risk of exceeding the maximum allowable exposure from trading. According to Article 159, a bank capital requirement for operational risk is calculated using one of the following approaches: simple, standardized, or advanced which are arranged in three subsequent articles. The first paragraph of Article 163 implements Article 108 of Directive 2006/48/EC. The concept of exposure to individuals is defined in the second paragraph of Article 163. The concept of a group of related persons (the second paragraph of Article 163 of the BAN - 1) is defined in Article 30.

Basic rules of risk management are set in Sub-section 4.6.1. Article 173 highlights the management responsibility for the adequacy of the risk management of the bank. Other general risk management rules applicable to all kinds of risks are: the obligation to design and implement appropriate risk management measures (Article 174), the obligation to establish and implement appropriate internal risk management practices (Article 175), and the obligation to develop appropriate and impairment provisions (Article 176). In subsequent subsections, there are rules on the management of these risks, which implement the relevant criteria set out in Annex V of Directive 2006/48/EC. Sub-section 4.6.2. deals with the management of credit risks, sub-section 4.6.3 with the management of market risks, subsection 4.6.4 with the management of liquidity risk, subsection 4.6.5 with the management of operational risk, and in subsection 4.6.6 with the management of other risks.

Article 217 of BAN-1 regulates the authority and responsibility of the BS for the supervision of banks and carries in the arrangements in Article 40 of Directive 2006/48/EC. Persons, who have close relationship with the bank, and persons, to whom the bank has transferred significant part of their business processes, are inherently subject to supervision, and BS is responsible for their supervision. The same is the purpose of the supervision of the management board and the holders of qualifying holdings (fourth paragraph of Article 217). The first paragraph broadly defines the purpose of supervision, the second and third paragraphs highlight the importance of monitoring compliance with the rules on risk management; they implement Article 124(2) and 124(3) of Directive 2006/48/EC. In



accordance with Article 124(4) of Directive 2006/48/EC, a requirement for regular assessment and reporting is regulated in the fourth and fifth paragraphs. According to Article 233, which implements Article 144 of Directive 2006/48/EC, the BS discloses general information on the control by publishing it.

Articles 242 to 246 are to implement the first sub-paragraph of Article 136(1) of Directive 2006/48/EC, according to which the supervisory authority of banks which do not meet the requirements of the directive, must immediately carry out appropriate procedures and measures for proper adaptation. Articles 247, 248 and 249 transpose legislation of the second subparagraph of Article 136 (1) and Article 136 (2) of Directive 2006/48/EC.

According to the second sub-paragraph of Article 136(1) of Directive 2006/48/EC, the actions that can be imposed by supervisory authority include: (a) requirement to provide additional capital through the level of minimum capital requirements; (b) requirement, that the credit institution establishes and implements management system, processes, mechanisms and strategies, (c) requirement, that the credit institution has a specific policy provisions, or treatment of assets in calculating capital requirements, (d) prohibition or restrictions on the provision of some or all of the operations or network of credit institutions, (e) requirement to reduce the risks specific to the operations, products, or systems of credit institutions. Pursuant to Article 136(2) of Directive 2006/48/EC the supervisory authority can determine specific capital requirements over a range of minimum capital requirements set out in Article 75 of Directive 2006/48/EC. A credit institution which does not meet the requirements laid down in Articles 122 (appropriate organizational structure, respective internal procedures for monitoring large exposures) and 123 (relevant policies and procedures internal capital adequacy assessment - Article 126 of the BAN-1) is subject to other actions. In accordance with the arrangements in Directive 2006/48/EC, Article 247 sets out the grounds for further action while Article 248 provides for additional measures that may be ordered by the BS.

Directive 2001/24/EC implemented by BAN-1 brought new features. The obligation to inform the supervisory authority of the Member State in which the bank has a branch is

regulated in accordance with Directive 2001/24/EC. The purpose of the activation of guarantees is to prevent the spread of the impact of the lack of liquidity of individual banks to other banks. Article 265 arranges obligation to notify the supervisory authority of the Member State in which the bank has a branch, and the disclosure of obligations in this regard. The regulation in subsection 7.8.2. on cross-border liquidations also carries regime from Directive 2001/24/EC. Thus, the acts of supervisory authority of a Member State have direct legal effects in all Member States (Article 272). The supervisory authorities of the Member States should inform each other on the issue of those decisions (Article 273), the decisions should be published in the Official Journal of the EU (Article 274), creditors are allowed to present claims in the official language of the Member State (Article 275), the liquidator has in the other Member States the same powers as in the territory of the Member State where the bank is established (Article 276).

Article 278 of BAN-1 (in accordance with Article 42 of Directive 2006/48/EC) regulates the obligation of the BS to cooperate with the supervisory authorities of the Member State in which the bank, directly or through subsidiaries provide banking or other mutually recognized financial services. As a general rule set in Article 217, BS is responsible to perform all the acts in respect of the supervision over the performance of the bank's services in another Member State. Article 279 (in accordance with Article 43 of Directive 2006/48/EC), deals with the possibility of the BS for the performance review of operations by asking the supervisory authority of the Member State in whose territory is the bank branch, to do that. Article 280 (in accordance with Article 30 (2) of 2006/48/EC) regulates the obligation of the BS for appropriate control measures in respect of violations committed in the territory of another Member State. The provision (in accordance with Article 35 of Directive 2006/48/EC) regulates the obligation of the BS to inform supervisory authorities of the Member States in the area where the Bank provides banking and other mutually recognized financial services, and of the withdrawal of authorization to provide these services. Article 281 (in accordance with Article 41 of Directive 2006/48/EC) regulates the competence of the BS for the supervision of liquidity branch in the country. In the next article in accordance with Article 42 of Directive 2006/48/EC the BS has obligation to

cooperate with the supervisory authorities of the Member States which bank in the territory of the Republic of Slovenia performs banking or other mutually recognized financial services. Article 286 (in accordance with Article 43 of Directive 2006/48/EC) deals with the conduct review of operations of a branch bank of the Member States. Article 285 (in accordance with Articles 30 to 33 of Directive 2006/48/EC) regulates the control measures against the bank and the branch of a bank of a Member State, namely: the imposition of eliminating the violation, notification of the supervisory authority of the Member State that the bank failed to comply with the order, and a ban on the provision of services in the Republic of Slovenia (third paragraph).

In Sub-section 7.9.3, there are the provisions which are necessary for the implementation of Articles 125 to 134 and 137 to 143 of Directive 2006/48/EC. The rules of supervision on a consolidated basis, are much more precise than before. In addition, they also cover the supervision on a consolidated basis in relation to the mixed-activity holding company. The Article 287 (in accordance with Articles 125, 126 (1) and 126 (2) of Directive 2006/48/EC) regulates the competence of the BS for the individual positions of supervision on a consolidated basis. The Article 288 (in accordance with Article 126 (3) of Directive 2006/48/EC) sets out the basis for agreement on the transfer or acquisition of competences between the supervisory authorities of the Member States. The Article 291 (in accordance with Article 129 (2) of Directive 2006/48/EC) regulates the procedures of cooperation between supervisory bodies of companies included in the supervision on a consolidated basis, the decision to issue licenses for the use of certain types of approaches for calculating capital requirements. Article 292 (in accordance with Article 130 (1) of Directive 2006/48/EC) lays down the obligation of the BS to other authorities in the case of the extraordinary situation in the banking group. Article 293 (in accordance with Article 130 (2) of Directive 2006/48/EC) deals with the process of acquiring information from other supervisory authorities to avoid duplication. In accordance with Article 131 of Directive 2006/48/EC Article 294 deals with the obligation of the BS to regulate the relations of exercising supervision on a consolidated basis with other authorities. Arrangements of Article 295 (in accordance with Article 132 (1) and (2) of Directive 2006/48/EC) regulate

appropriate basis for the exchange of information between supervisory authorities of the Member States relating to supervision on a consolidated basis. It also establishes the obligation of the BS to consult with the supervisory authorities the decisions that are important for the other supervisory authorities. The Articles 297 and 298 (in accordance with Articles 133 and 134 of Directive 2006/48/EC) lay down the rules on the scope and methods of consolidation for the purposes of supervision on a consolidated basis. Article 299 defines the obligations of the mixed -activity holding company and its subsidiaries regarding supervision on a consolidated basis, Article 300 regulates control over transactions between the mixed-activity holding company and its subsidiaries. Article 301 (in accordance with Article 139 (1) of Directive 2006/48/EC) regulates the exchange of information for the purposes of supervision on a consolidated basis among the supervisory authorities involved. Article 302 (in accordance with Article 140 (1) of Directive 2006/48/EC) regulates cooperation arrangements with supervisory authorities responsible for the supervision of insurance companies, which are included in the banking group. Furthermore, BAN-1 regulates control of parent financial holding companies and mixed-activity holding company. The rules laid down in Article 307 (in accordance with Articles 127 (1) and 139 (3) of Directive 2006/48/EC) deal with responsibility for the supervision of the BS on an individual basis to those legal entities that are not banks, and over which it exercises supervision only because of proper supervision on a consolidated on the operation of banks. For regular liquidation of a bank the general rules of the Companies Act on liquidation of joint-stock companies are used (fourth paragraph of Article 76). In the Articles 76 to 79 of BAN-1 special (additional) rules for the liquidation of the bank on a regular basis are set. The regulation of the second, third and sixth paragraphs of the legislation transpose Directive 2001/24/EC.

Otherwise, rare, there are certain parts of Directive 2006/48/EC, which have not been transferred to the Slovenian legislation. Such parts are:

- the first paragraph of Article 64 of Directive in its entirety. It, namely, provides rules for credit institutions set up as cooperative societies. In fact, there are no credit institutions in the form of cooperatives in Slovenia.
- the eighth paragraph of Article 80 article in its entirety. It deals with exempt exposure of the credit institution to a counterparty which are included in the same institutional protection scheme as the lending credit institution and to determine risk weighting of 0%. According to the BS, this part of the directive was not taken up because the BS decided not to use the corresponding discretion.
- the second, third and fourth subparagraphs of Article 114, which provides that the competent authorities must ascertain the suitability of the estimates produced by the credit institution for use in reducing the exposure value for the purposes of compliance with the provisions. If a credit institution is permitted to use own estimates of the effects of financial collateral, it must do so in accordance with the approach used for the calculation of capital requirements. Slovenia in this case did not use the inherent discretion, and implementation of these provisions was needed.

In some individual paragraphs of Directive 2006/48/EC, some points have not been implemented or have been implemented only partially (I e, first paragraph of Article 63. points a, b, c, first and second paragraphs of Article 94). Most cases in which Slovenia has not transposed the provisions of the directive into national law, is a consequence of unused discretion. Where this was not the case, a large part of non-compliance or weaknesses of the implementation was lifted to the amendments. Regarding Directive 2006/49/EC there has been even less non-implemented rules than in Directive 2006/48/EC.

### **4.3. Liberalisation of capital movements**

The Europe Agreement signed by the Republic of Slovenia and the European Community and its Member States came into force on February 1<sup>st</sup>, 1999. As regards capital movement liberalization, a four-year transitional period relating to controls on short-term capital movements was agreed. The Government of the Republic of Slovenia made a commitment already in 1999, within the framework of its negotiating position to bring the scope and

concept of capital movements in line with the acquis. As for the lifting of sector-specific restrictions further liberalization was linked to amending legislation governing the respective areas. A significant step towards alignment with the acquis in the field of 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 effectiveness of the Foreign Exchange Act, cross-border credit transfers were completely liberalized, though the restrictions in relation to short-term capital movements remained in place. In 1999, the Government made a commitment in the relevant common negotiating position that the legislative framework of the Republic of Slovenia concerning free capital flows will be gradually harmonized with the *acquis communautaire* before the date of the country's accession to the EU. As from the promulgation of the Foreign Exchange Act in 1999, the 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, and to prepare a liberalization timetable with milestones in the process of removing the remaining restrictions on capital flows with target dates and an outline of interim liberalization steps, the BS in June 1999 adopted a timetable for the liberalization of cross-border capital movements. The BS made a commitment to abolish the existing restrictions on some capital movements no later than by the milestones set out under the liberalization timetable. Major changes were introduced in 2001 and 2002. With effect from January 1<sup>st</sup>, 2001, BS cut back the period after which a non-resident does not have to pay the premium on the right to purchase foreign exchange from one year to six months. With effect from July 1<sup>st</sup>, 2001, BS liberalized purchases of non-residents in the domestic capital market, while it retained their obligation to pay the premium for the purchase of foreign exchange from the BS, and for the purchases of investment coupons of mutual funds. On July 1<sup>st</sup>, 2001, BS abolished the restrictions on opening of current and deposit accounts abroad for legal entities. At the same time, the limits on residents purchase of securities abroad (which stipulated that residents may purchase other securities only through a stock exchange, which is member of the International Federation of Stock Exchanges (FIBV))

were lifted. On January 1<sup>st</sup>, 2002, all restrictions on purchases of non-residents in the domestic money market were lifted; non-residents might buy and sell securities without restraint. At the same time, transfers of domestic and foreign cash into and out of the country were fully liberalized. Therefore, cash could be brought into and out of the country under the terms and in accordance with the Money Laundering Prevention Act.

#### **4.4. Cross-border competition and permitted activities**

The new Banking Act 1999 introduced the possibility for foreign banks to establish branch offices in Slovenia but they are not independent legal persons. In line with the Second Council Directive, the new Banking Act introduced a uniform banking license, clearly differentiating between banks from EU member states and those from other foreign countries. The Second Council Directive makes it possible for banks domiciled in EU member states holding a banking license issued by their authorities in charge to provide such banking services in any other member state, be it in form of a branch or subsidiary. The above differentiation was to become effective with the date of full membership of Slovenia in the European Union. Until then, the banks domiciled in the EU member countries needed the banking license of the BS for establishment of a branch and would not be allowed to provide banking and financial services directly. As a condition to such banking license, the BS might require endowment capital in form of a deposit or other form of guarantee for settlement of any liabilities of such branch deriving from its operation in Slovenia. Branches of foreign banks were subject to supervision by the BS.

Pursuant to the Banking Act 1999 a bank that intends to open a branch office in a Member State should inform the BS; the notification shall be accompanied by: the description of the activities to be performed by branch and its business plan; the names of the persons authorized to manage the branch; address of the branch in the Member State in which it was possible to obtain documentation on the branch (article 44). BS should submit the notification to the competent supervisory authority of the Member State. The BS was to supervise bank branch in a Member State or might apply to the competent supervisory authority of the Member State (article 46).

According to Directive 2006/48/EC (previously: Directive 2000/12/EC) and Annex I (List of activities subject to mutual recognition), a bank of a member-state that is entitled to provide banking services and other (mutually recognized) financial services may also provide these services in Slovenia. It can provide them via a branch (in the case of permanent pursuit of business) or directly (in the case of occasional provision of services without elements of a permanent presence in Slovenia).

#### **4.5. Capital Adequacy**

According to the Banking Act 1999 bank can only be established as a limited company with the minimum share capital 1.000,000.000 SIT. (article 15); the core capital of the bank consisting of: paid-up share capital and share premium, unless paid-up share capital and capital surplus are 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; other items which are by their nature the same items. 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 must 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 may never be less than the minimum amount of share capital. The minimum capital adequacy ratio (the ratio of bank capital and risk-weighted assets) must 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 may not exceed the total amount of capital. In the investment banks the capital of non-financial organizations may not exceed 60% of the bank's capital. The investment in the first three years following the acquisition are not considered investments acquired by the bank rather than the fulfillment of financial obligations of legal entities in the financial reconstruction of this person.

To ensure capital adequacy and liquidity banks were prohibited to distribute profits and participation in the profit of the Management Board, Supervisory Board or employees if the



capital is below the minimum capital, if the bank does not guarantee the minimum amount of liquidity, if the bank does not comply with eliminations of violations ordered by BS. If BS considers that, to ensure the solvency of a bank or the elimination of the causes of illiquidity or insolvency, it could request a general meeting of shareholders and propose the adoption of a decision on an increase in share capital with new cash.

In October 2001, BS passed a decision on the minimum level of liquidity to be maintained by banks, unifying the monitoring of Tolar and foreign currency liquidity. The decision required daily disclosure of banks' actual liquidity ratios with effect from July 1<sup>st</sup>, 2002. This ensured daily monitoring as well as regulation of all agreed monetary flows through calculation of the liquidity ratios in banks. Liquidity ratio was calculated as the ratio of claims and liabilities by term to maturity, separated into a Tolar and foreign exchange portion within category one (0 to 30 days term to maturity) and category two (0 to 180 days term to maturity), and were set at 1.0. The decision also prescribed a minimum volume of liquid foreign currency claims and compulsory subscription for BS foreign currency bills. In category two (0-180 days) of the foreign exchange part, banks were obliged to ensure that on any given day the sum of foreign currency claims is equal to at least 80% of the monthly average of balance sheet liabilities in category two of the foreign exchange portion in the previous calendar month. In July 2003, an amendment enabled banks, in the event of a long foreign currency position in achieving the minimum volume of liquid foreign currency claims, to additionally take account of claims arising on the basis of foreign currency credit extended to residents, except to the Republic of Slovenia and other banks, irrespective of maturity.

New changes were introduced by the Banking Act, 2006. Article 2 explicitly transmitted provisions of the Directive 2006/48/EC on the taking up and pursuit of the business of credit institutions and Directive 2006/49/EC amending Council Directive 93/6/EEC on the capital adequacy of investment firms and credit institutions. The minimum amount of the share capital of a bank was put to € 5,000,000 (article 42). The bank's shares might be denominated in name, issued in dematerialized form, paid in cash in full prior to enrollment and the establishment of the capital increase in the Register. The bank should

not, directly or indirectly lend or issue guarantees for the purchase of its own shares or shares in companies in which the bank holds at least a 20 percent share. The prohibition of lending or guaranteeing also applies to other financial instruments issued by a bank or a company in which the bank holds at least a 20 percent share. Capital adequacy ratio must ensure that a bank always has an adequate capital, given the volume and type of services it provides and the risks to which it is exposed in the provision of these services (article 125). The bank must operate so that it is at all times able to meet liabilities when due and to be permanently able to meet all its obligations. Regulations on risk management were to be prescribed by the BS (article 129)<sup>18</sup>.

By July 2006, BS introduced a new collateral system that applied the criteria used by the Eurosystem, but that also allowed some features specific to Slovenia. The main changes in the new system were the introduction of the list and the pool of eligible financial assets that the banks can use to collateralize the credit operations. The introduction of the pool of eligible assets changed the way in which credit operations are collateralized, with individual credit transaction no longer being earmarked with specifically defined asset, but rather with the pool of eligible assets. At the same time, the BS also changed the active valuation of collateral on a daily basis, taking risk management measures into consideration. Slovenian Accounting Standards envisaged five credit rating categories while IFRS methodology envisaged nine credit rating categories.

In accordance with the new Regulation on the Assessment of the Credit-Risk Losses of Banks and Savings Banks, taking the IFRS into consideration, a bank can create any percentage impairment or provisioning. Classifying claims with the new impairment or provisioning percentages of the old rating categories caused a migration of some A-rated claims to the B-rated claims, which did not necessarily entail any deterioration in the quality of these claims. Capital adequacy which fluctuated between 11% and 12% after 2001, finally reaching new low of 10.5% at the end of 2005. The ratio improved significantly in 2006, but the increase in capital adequacy was the result of the changeover to the IFRS, owing to the abolition of certain types of provisions and the decline in currency-risk-

weighted assets. The capital adequacy of the Slovenian banking system stood at 11.1% as at December 31<sup>th</sup>, 2006.

#### **4.6. Large Exposures**

To curb excessive concentration of credit exposure to a single client and a group of connected clients is generally considered to be a key element of credit risk management. Enacted in 2001, modifications and amendments to the Banking Act in addition to large exposure limits of 25% and 20% introduced a 10% limit in exposures to persons in a special relationship with a bank as stipulated in Article 83 of the Banking Act.

#### **4.7. Deposit Guarantee Scheme**

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 (Official Gazette of the Republic of Slovenia, No. 7/99), which became effective on January 1<sup>st</sup>, 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 in the Decision on Deposit-Guarantee Scheme (Official Gazette of the Republic of Slovenia, No. 61/00) and the Decision on Adaptation of Minimum Initial Capital of Banks, Guaranteed Deposits and Minimum Initial Capital of Savings Banks (Official Gazette of the Republic of Slovenia, No. 102/00).

The mechanism of the scheme is to be activated by the bankruptcy proceedings in a bank or a savings bank providing repayment of guaranteed deposits placed by individual depositors in the amount of up to 4.2 million Tolars (approximately 20,000 Euros). Guaranteed deposits would be repaid from liquid funds provided by the BS by a bank appointed by the BS no later than three months after bankruptcy proceedings in the failed bank or a savings bank were initiated.

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. The branches of foreign banks were obliged to invest at least 2.5 per cent of the balance of guaranteed deposits placed with the respective branch.

As from the day of full-fledged membership of the European Union, deposits placed with the branch of a bank from a Member State will be guaranteed under the deposit-guarantee system effective in the Member State, provided BS recognizes the deposit-guarantee scheme in place in the Member State as equal to the scheme provided in the Republic of Slovenia. Branches of foreign banks may be included in the deposit-guarantee scheme in place in the Republic of Slovenia for supplementary cover. Before Slovenia accession, the Bank of Slovenia may at its discretion rule require for the authorization to establish a branch of a foreign bank that the branch joins the deposit-guaranteed scheme in the Republic of Slovenia, in the case where the deposit-guarantee scheme of the home country falls short of the level of protection provided in the Republic of Slovenia.

Under the Deposit Guarantee Scheme of the Republic of Slovenia and in line with the Banking Act 2006, deposits in banks or saving banks with the headquarters in Republic of Slovenia were covered up to EUR 100,000. The calculation of the guaranteed deposit amount for individual persons, legal entities, individuals engaged in business activities, and entrepreneurs 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. In the event of bankruptcy the guaranteed deposits will be paid out within 20 working days from the commencement date of the bankruptcy procedure. A subsidiary of a foreign bank is included in the deposit guarantee scheme in the country where the bank was established. If the deposit guarantee scheme in the country in which the foreign bank does not exist or the extent of the deposit guarantee scheme is less than in the Republic of Slovenia, a branch of a foreign bank was to be included in the deposit guarantee scheme in Slovenia. The guaranteed deposits in foreign currencies shall be paid in euro- equivalent amount at the rate of exchange published by the BS on the commencement date of bankruptcy procedure. Deposits at banks from Member States of the European Economic Area which provide

banking services in Slovenia directly or via a branch are guaranteed under the deposit guarantee schemes in the country where the bank is established.

The regulation in the field changed often. European legislation applied were Directive 94/19/EC of the European Parliament and of the Council, Directive 2009/14/EC amending Directive 94/19/EC while national legislation: Banking Act (O.G. of RS, No. 99/10-official consolidated version, ZBan-1E) Banking Act (O.G. of RS, No. 35/11, ZBan-1F), Banking Act (O.G. of RS, No. 59/11, ZBan-1G) Banking Act (O.G. of RS, No. 85/11, ZBan-1H), Banking Act (O.G. of RS, No. 48/12, ZBan-1I) Banking Act (O.G. of RS, No. 105/2012, ZBan-1J), Regulation on the Deposit Guarantee Scheme (O.G. of RS, Nos. 97/10, 26/12, 75/12, 29/13)

#### **4.8. Legislation affecting banking supervision**

On January 17<sup>th</sup>, 2002, BS adopted the Action Plan to improve compliance with the Core Principles for Effective Banking Supervision based on the findings of the Peer Review Mission that visited Slovenia at the end of September 2001. In accordance with the Action Plan, the BS endorsed the following:

1. Additional resources will be secured for uninterrupted research activities of the Banking Supervision Department.
2. An initiative to amend the provisions of the Banking Act concerning licensing and shareholders' structure of banks will be made to enable banking supervisors to get strong instruments for control in the issues related to a bank's owners and exercising oversight over banks' capital investments in other entities. When acquiring a qualifying holding (above 10%) of voting rights or of the bank's capital, in accordance with the EU Banking Directive it will be obligatory to obtain a prior authorization from the BS. Such an authorization will also be required for major capital investments that banks may decide to make in other entities.
3. As regards banks' lending and investment policy, large exposure limits and extending loans and advances to connected persons will be at the focus of supervisory efforts. More specifically, the provisions of the Article stipulate that banks may not conclude new

business during the transitional period which could lead to an increase in unauthorized exposure.

4. The requirements for management and control of market risks on a consolidated basis will be implemented alongside with the implementation of the provisions related to capital requirements for market risks. As regards the regulatory area the stress will be on developments around the world and adding to regulations and to legal basis if needed to become fully compliant with the standards advocated by the Bank for International Settlements (BIS), or EU directives referring to the banking sector. By enacting an appropriate modification to the Banking Act and secondary legislation, detailed quantity and quality standards to be met by internal models with regard to management and control of market risks.

In 2007, secondary legislation affecting banking supervision was issued primarily due to the new Banking Act (Official Gazette of the Republic of Slovenia, No. 131/06) and due to continuing harmonization with Directive 2006/48/EC and the opinions of the Capital Requirements Directive Transposition Group (CRDTG).

#### **4.9. Accounting**

Regulation EC/1606/2002 adopted in June 2002 requires of EU banks to apply the International Financial Reporting Standards (IFRS) to their consolidated financial statements for financial years after 2005. Slovenian banks had to apply the IFRS in compiling their financial statements for the 2006 financial year. Accounting in accordance with the IFRS required that banks monitor the values of certain accounting items at fair value instead of a historical cost which had been the prevailing valuation method in the past. At the same time, the change in the concept for valuing balance sheet items also had an impact on the estimation of credit risk losses and on the creation of provisions or impairments of financial assets. The current creation of provisions and impairments is a direct result of a past event providing indisputable evidence of a downgrading in the claims against the individual debtor. This ensured that the values of claims are monitored in line with the bank's currently available information, and their fair values, and only to a lesser

extent in line with the statistically determined probability of loss over the longer timeframe or assessments of the future performance and risks of a particular debtor.

Regulation on the books of account and annual reports of banks and savings banks defined in detail the types and layouts of financial statements and consolidated financial statements of banks and savings banks, the detailed content of annual reports and consolidated annual reports and the contents, form, method and deadlines for the submission of monthly reports on the account items of banks. Regulation was introduced by different instructions of the BS entitled guidelines or regulations such as:

Guidelines for preparation of the balance sheet and income statement of banks and savings banks, Guidelines for calculating performance indicators of banks and savings banks, Guidelines for submission of monthly reports of account balances, Regulation on the auditing of the annual report of banks and savings banks, Regulation on the information that must be published by branches of Member State banks, Regulation on the reporting of branches of Member State banks, Regulation on the reporting of certain facts and circumstances relating to banks and savings banks prescribing additional reporting, Guidelines for implementing the regulation on the reporting of capital and capital requirements of banks and savings banks, Regulation amending the regulation on the supervision of banks and savings banks on a consolidated basis, Regulation amending the regulation on the reporting of certain facts and circumstances relating to banks and savings banks, Regulation amending the regulation on the books of account and annual reports of banks and savings banks.

#### **4.10. Investment Services**

The legal framework adopted in 1999 regulated the securities market and established the supervisory authority. Aiming at harmonization of the existing legislation with EU directives, the Dematerialized Securities Act and the Securities Market Act were adopted in 1999. The new Securities Market Act was based on the principles ensuring transparency, safety and prudence, honesty in operation and introduced supervision of the market. Among others, the law specified more systematically the conditions and the procedures for public

offerings. It also imposed stricter capital requirements on stockbrokers, introduced stricter risk management rules based on EU directives.

The Securities Market Law stipulated the procedures of operation of organized markets and fulfillment of obligations from transactions on such market, and specified transactions with standard financial instruments. Pursuant to the law, the Securities Market Agency is an independent public institution in charge of supervision of the securities market and of its participants. Its legal standing was comparable to that of the BS with the tasks and responsibilities in the non-bank sector similar to those of the BS in the banking sector.

One of the features of the Slovenian financial market has been the prevalence of monetary financial institutions. The share of non-monetary financial institutions added up to between 20% and 25% of aggregated assets of the Slovenian financial system. At year-end 2001, the breakdown of non-monetary financial institutions showed 35 authorized investment companies, 18 mutual funds and 15 insurance undertakings (10 conventional insurance undertakings, 2 reinsurance undertakings and 3 specialized public institutions). Slovenia adopted the legal framework in early 2000 for the provision of voluntary supplementary pension insurance. At year-end 2001 the list of operators of pension schemes featured 7 mutual pension funds and 6 pension companies. Among the financial institutions that provided brokerage services were 11 banks and 20 stock-broking companies. At the end of 2003, the non-monetary financial institutions included 26 investment companies (including 18 privatization funds), 20 mutual funds and 14 insurance companies (12 insurance agencies and 2 reinsurance companies), five mutual pension funds, four pension companies and three insurance agencies. In line with the Act Amending the First Pension Fund of the Republic of Slovenia and Transformation of Authorized Investment Corporations Act, privatization funds had to convert into investment companies and/or ordinary public limited companies by the end of 2003. Insurance companies are the largest group of non-monetary financial institutions. The primary securities market in Slovenia remained underdeveloped. By far the dominant share issuers were non-financial companies (78% of the total value), followed by banks (10%), other financial intermediaries (9%) and insurance agencies (3%), while the largest group of shareholders were non-



financial companies (29%), followed by consumers (20%), the government (18%), other financial intermediaries (18%), the rest of the world (13%), banks (4%) and insurance agencies (2%). The most important bond issuer was the government (83% of the total by value), followed by banks (13%), non-financial companies (3%) and insurance agencies (1%). The main holders of bonds were banks (43%), insurance agencies (25%), consumers (13%), the government (6%), non-financial companies (5%), other financial intermediaries (5%) and the rest of the world (3%).

#### **4.11. Payment System Reform**

One of the reforms in the financial system was adaptation of the payment system. 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 goal of the reform was the migration of accounts of legal persons from the Agency for Payments to banks. 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. The foundations of the project had been set out in a document entitled *Needs for Change in the Slovenian Payment System* (September 1994), strategic decisions were adopted in 1995 and operational plan for the transition to the new payment system was drawn up in 1996. The institutions involved in this reform were BS, Ministry of Finance, Agency for Payments, commercial banks, savings banks, Banking Association of Slovenia, and Statistical Office of the Republic of Slovenia. To facilitate the changeover, detailed guidelines for conducting payment transactions for the account of legal persons and the migration of accounts of legal persons to the banking environment were drawn up on the basis of the Law on the Agency for Payments. A special document *Substantial Changes at Migration of Accounts* elaborated on the necessary changes and proposed solutions to overcome problems associated with the migration. Both documents were prepared by BS and reconciled with the officials of the Ministry of Finance, including Tax Administration and the Agency for Payments. The documents served as a foundation for the experts of the BS and the Ministry of Finance to prepare guidance notes relating to organizational and technical matters. At the end of July 2000, the eligible banks obtained the special authorization granted by the BS and the Ministry of Finance, and September

11<sup>th</sup>, 2000 the migration of accounts commenced. In addition to the migration of accounts of legal entities, other activities concerning payment systems were proceeding with the aim to improve the structure and the operating mode of the payment systems and consequently boost their effectiveness as far as risks and costs are concerned. Though groundwork was somewhat more difficult than expected, the migration process was going on steadily and smoothly along the set guidelines and the migration process was completed by the end of June 2002, when the Agency for Payments ceased to perform payment services..

On March 20<sup>th</sup> 2002, Payment Transactions Act (Official Gazette of the Republic of Slovenia, No. 30/02) regulating the conduct of payments in Slovenia was passed. The act addressed institutional, material and operational issues connected with the carrying out the payment services, defined the relationship between the providers of payment services, specified the minimum requirements for the regulation of relations between providers and the users of payment services, and set the minimum criteria for the provision of payment services. The act addressed the settlement of liabilities between providers of payment services and distinguished between high-value and small-value payments. Management of the system for high-value payments will be entrusted to the BS and they would be effected in real time while for retail payments licenses to carry out the payment services were issued and BS would supervise regularity and legality. One of the areas addressed under the Payment Transactions Act was issuance of electronic money. The provisions of the act were harmonized with Directive 2000/46/ES that addresses the carrying out of services and oversight of the carrying out of services related to the issuance of electronic money. The act dealt also with the dissolution of the Agency for Payments and the established the Public Payments Administration (UJP) within the framework of the Ministry of Finance and the Agency of the Republic of Slovenia for Public Finance Records and Services (AJPES) which took over other tasks of the Agency.

At the end of June 2002, BS also opened accounts for members of the Central Securities Clearing Corporation who were at the same time members of the payments and transfers system. In accordance with Article 151 of the Securities Market Act funds of customers of stock-broking companies must be managed in separate cash accounts. The BS oversees

the operation of payments systems with the aim of ensuring their effectiveness and safety, particularly through preventing the possibility of a spread of financial problems on the part of one participant in the system to others or to the system as a whole (systemic risk or the domino effect). The BS performs its role in accordance with internationally accepted principles for the oversight of payment systems (Core Principles for Systemically Important Payments Systems). The payment systems oversight function must be distinguished from that of banking supervision. Supervision involves responsibility for regulating individual financial organizations, including their involvement in payment systems, while oversight of payment systems concentrates on the payment system itself.

The aim of oversight of the payment system by BS was first to protect the financial system from the potential systemic consequences of one or more participants in the payment system facing financial difficulties, and second to ensure operational security and efficiency in the operation of the payment system. Oversight of the payment system focused on the system itself and not individual participants in it. In the majority of countries where the central banks (including the ESCB) apply the uniform standards drawn up by a working group at the Bank for International Settlements in the oversight of the payment system, namely the Core Principles for Systemically Important Payment Systems. The Core Principles stipulate the minimum requirements to be fulfilled by all systemically important payment systems in a country, whereby the central bank rules on the (systemic) importance of a particular payment system. The BS should therefore ensure that all other interbank payment systems are in line with the guidelines of the Core Principles. In 2003, BS commenced preparation of the guidelines for connection to the pan-European payment systems TARGET and STEP2. TARGET (Trans-European Automated Real-Time Gross Settlement Express Transfer System) is the system for interbank settlement of cross-border payments in Euros in the EU in real time, and began operating on 1 January 1999. The objective of the system is to provide support for the implementation of monetary policy in the Eurosystem and to ensure that payments are executed securely, reliably and efficiently, with the fundamental aim of contributing to integration and the stability of the euro money market. Domestic payments are settled within the individual national RTGS

system, while cross-border payments are settled between the systems connected to TARGET.

Activities related with ensuring and maintaining the secure operation of payment systems took place in 2003. In January 2003, the RTGS system was upgraded the essence of the upgrade was that each transaction in the RTGS system is also recorded at the reserve location. In the event of any major problems at the primary location, it will therefore be simpler and quicker to establish the operation of the RTGS system at the reserve location.

On joining the EU Slovenian banks also 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 in favor of joining STEP2 via the BS. On November 8<sup>th</sup>, 2004 BS became a direct participant in the STEP2 system, with the banks participating via the BS having indirect participant status.

## **5. The crisis and the instability enhanced by regulation (2007-2013)**

### **5.1. Exposure of the non-financial corporations**

The global financial crisis did not affect Slovenia until the end of 2008. But when the financial and economic crisis deepened in 2009, the very open Slovenian economy was unable to avoid the decline. Manufacturing companies were hit by the drop of foreign demand, the congested construction activity crippled investments. 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, but the cost was high general government deficit and large increase in public debt. As imports fell even more than exports, current account came almost in balance which eased the pressure to expand private sector borrowing abroad. 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 export-oriented manufacturing industries and its contribution to GDP by net trade surplus which was also partly the result of 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. Even 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 was not excessive public debt but over-leveraging in the private business sector and austerity measures.

## **5.2. Increased volatility of the banking system**

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<sup>19</sup>. The effects were enhanced by high banking orientation of Slovenian non-financial 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. By the crisis, 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. Regulators who were also lenient before the crisis became hard-hearted. 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. 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 factor in the maintenance of bank balance sheets was government borrowing abroad and depositing the money in the banks to provide lending potential. 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 demagoguery against crediting "tajkuns" 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 they recorded only a modest increase in deposits of households. 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-banking sectors 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. Excessive funding on international financial markets and aggressive lending to increase or retain market share at home, proved to be fatal. As a result of repayments of liabilities on the wholesale financial markets and their relatively low capital adequacy, the banks faced a contraction in their balance sheets and the tightening of credit standards.

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 for 5.2% of claims. With 3.8% of their classified claims more than 90 days in arrears, households remained relatively low-risk, partly due to very low 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. This implied high costs of already limited corporate financing and the banks' limited capacity to generate supply of credits (see Graph 3).

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 regulation. A contraction in turnover, though not considered the right way to meet the capital requirements, was unavoidable outcome. Although the banks improved their capital structure and capital adequacy, 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.

### **5.3. Changes in regulations**

#### **5.3.1. Deposit guarantees**

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. On this basis, BS issued the *Regulation amending the Regulation on the Deposit Guarantee Scheme* and amended the *Instructions for Compiling and Submitting Reports on Guaranteed Deposits*. 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. Banks had to report the balance of guaranteed deposits to BS on a quarterly basis, and reporting deadlines have been shortened to one month.

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). A new *Regulation on the deposit guarantee scheme*, linked to changes in the area of deposit guarantees as the result of the new ZBan-1D, was issued at the beginning of the year. Amendments to the regulation derived from an increase in the guaranteed deposit amount from EUR 22,000 to EUR 50,000, a new definition of net deposit, changes regarding deposits excluded from the guarantee scheme and the treatment of deposits on custodian accounts. Therefore, the BS *Guidelines for completing and submitting guaranteed deposit reports* were reissued. The new ZBan-1E, published in October 2010, once again brought changes to the deposit guarantee scheme linked to the transposition of the provisions of the new guarantee directive into Slovenian law.

#### **5.3.2. Persistent changes in the capital adequacy regulation**



In 2007, secondary legislation affecting banking supervision was issued primarily due to the new Banking Act (Official Gazette, No.131/06; ZBan-1) and due to continuing harmonization with Directive 2006/48/EC and the opinions of the Capital Requirements Directive Transposition Group (CRDTG). 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 (2006/49/EC): Directive 2009/111/EC (the so-called CRD II directive), 2009/83/EC and 2009/27/EC. Bank of Slovenia regulations required amending owing to the transposition of these regulations and the introduction of guidelines by the Committee of European Banking Supervisors. Given that, the CRD II brought about more significant changes with regard to the treatment of own fund instruments, large exposures and securitization, the most significant changes were made to the regulations that govern these areas: *Regulation on the calculation of the capital of banks and savings banks*, *Regulation on large exposures of banks and savings banks*, *Regulation on the calculation of capital requirements for credit risk in securitization*, and the *Rules regarding the exposure of banks and savings banks to credit risk transfer*. The CRD II directive resulted in more significant changes to liquidity risk management, which is governed by the *Regulation on risk management and implementation of the internal capital adequacy assessment process*. Changes to other regulations were primarily of a technical or editorial nature. In accordance with the deadlines for the transposition and entry into force of the new rules set out in the EC directives, the regulations were published in October and entered into force on 31 December 2010.

Most of the changes to banking regulations in 2011 were related to the transposition of Directive 2010/76/EU of 24 November 2010 regarding capital requirements for the trading book and for re-securitizations, and the supervisory review of remuneration policies (the CRD III). 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, namely the *Regulation on the calculation of capital requirements for credit risk under the standardized approach for banks and savings banks* and the *Regulation on the calculation of capital requirements for credit risk under the internal ratings-based approach for banks and savings banks*, which brought minor changes for Slovenian banks deriving from the CRD III. A broad package of regulations was adopted on December 2011 to transpose the remaining provisions of the CRD III into the Slovenian legal system. These were updates to the *Regulation on the calculation of the own funds of banks and savings banks*, the *Regulation on the calculation of capital requirements for credit risk in securitization and the rules on the exposure of banks and savings banks to transferred credit risk*, the *Regulation on the calculation of capital requirements for market risks for banks and savings banks* and the *Regulation on disclosures by banks and savings banks*.

The most significant change brought in accordance with the CRD III by the new *Regulation on the calculation of capital requirements for credit risk in securitization and the rules on the exposure of banks and savings banks to transferred credit risk* is stricter treatment of re-securitization positions relative to “ordinary” securitization positions via a higher risk weight for the purpose of calculating capital requirements. The CRD III required the calculation of capital requirements for securitization positions in the trading book, which equalized the treatment of positions with regard to the banking book.

The *Regulation on the calculation of capital requirements for market risk for banks and savings banks* was primarily amended in the part relating to 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. Banks that used an internal approach to calculate separate position risk had to calculate an additional capital requirement for excess default and migration risks, while the model could also capture price risks in the

trading portfolio. Given the amendments to the regulations governing the calculation of own funds and capital requirements, it was also necessary to amend the *Regulation on the reporting of the own funds and capital requirements of banks and savings banks*, and the *Guidelines for the electronic submission of reports on own funds and capital requirements*, which regulated the form and method of electronic reporting.

Amended in March 2012 was the *Regulation on the calculation of capital requirements for credit risk using an internal ratings-based approach*, whereby banks intending to use the IRB approach were, in line with practices in other EU member states. It provided the opportunity to extend the envisaged five-year period for the gradual introduction of the IRB approach.

### **5.3.3. Changes of the banking regulation in 2012 and 2013**

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 the 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 passed in December 2012. The objective of the ZBan-1J has been 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. The BS may adopt measures 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 complies 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.

Recently, in addition to these acts, other amendments to the Banking Act and regulations that enhance corporate governance were adopted. The new *Regulation on the diligence of members of the management and supervisory boards of banks and savings banks* imposes the following: the determination of criteria for defining significant direct or indirect business contacts for the purpose of identifying conflicts of interest, the detailed definition of tasks and the composition of a remuneration committee, and detailed criteria for determining the significance of a bank for the purpose of appointing a remuneration committee, and the determination of criteria and procedures for the assessment of a bank in terms of the suitability of management or supervisory board members or already appointed members holding such office. The amended regulation transposed the EBA

guidelines on the assessment of the suitability of members of the management or supervisory body and key function holders (EBA/GL/2012/06) into Slovenian legislation.

A new Banking Act (ZBan-2) is expected to be adopted in the first quarter of 2014. The main purpose of the new act is to implement Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amendments to Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (CRDIV) and to also define the elements of prudential requirements specified in (ii) Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (CRR). The ZBan-2 is expected to also include the required adjustments for implementing procedures in connection with the regulation outlining the Single Supervisory Mechanism (Council Regulation (EU) No. 1024/2013) and the Bank Recovery and Resolution Directive (BRRD).

The Slovenian framework for crisis management of banks should completely adapt to future uniform regulations that will be prescribed by the BRRD and the Single Resolution Mechanism (SRM) of the EU regulation. The framework should outline required measures, procedures and authorizations with which banks could be rescued in a manner which prevents financial instability and at the lowest possible cost for taxpayers. The government shall set out in more detail the authorities for performing functions and tasks associated with the rescue and ensure that the present crisis management system, involving the rescuing and restructuring of institutions within Slovenia's financial system and in the scope of cross-border cooperation with other EU member states, will adapt to the EU framework for crisis management.

## **6. The breakdown and the restoration? of the banking system (2013-2014)<sup>20</sup>**

### **6.1. Credit Crunch**

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 accounting for just 3.2% of the banks' total non-performing portfolio. The proportion of non-performing claims more than 90 days in arrears or rated in the lowest categories (D and E) had 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. The operating losses had an adverse impact on capital adequacy. Insufficient capital increased, resulting in maintaining the capital adequacy ratios solely by reducing lending activity. Though this ensured, despite high impairments, a stable level of capital, the capital adequacy ratios remained below the average of comparable banks across the EU.

Due to the deteriorating situation in the banking sector and with the aim of ensuring financial stability the Measures to Strengthen the Stability of Banks Act (ZUKSB) was passed at the end of 2012. It 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.

## **6.2. Asset Quality Review and Stress Tests**

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 tested methods and international standards used in comparable reviews previously conducted within the EU.

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 deficit in the case of the realization of a very unlikely but still possible scenario. The reason for using such an extreme scenario was said to assess the robustness of the Slovenian banking system in the most adverse hypothetical stress developments. Ten banks and banking groups which together constitute approximately 70% of the Slovenian banking system were involved in the review. Alongside the three systemically important banks and/or banking groups, NLB, NKBM and Abanka, also Gorenjska banka, Banka Celje, UniCredit Banka Slovenija, Hypo AlpeAdria-Bank, Raiffeisen banka, Probanka and Factor banka were included in the review. Probanka and Factor banka were subsequently excluded from the stress tests because of the initiation of an orderly liquidation procedure in September 2013.

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 stress tests were determined by an inter-institutional committee after consultations with the European Commission (EC) and the European Central Bank (ECB)<sup>21</sup>. 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 measures under the ZUKSB (NLB, NKBM, Abanka) covered 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 for 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 sectors and claims from off-balance-sheet liabilities to these sectors (exposures to SMEs, to large companies, to the construction sector, household exposures secured by residential real estate, other household exposures). 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 (losses from performing and non-performing claims and from restructured claims in various portfolios; losses from investments in securities); a bank's loss absorption capacity (the stock of impairments and provisions for the observed portfolio at the end of 2012, the bank's ability to generate profit before the creation of impairments and provisions, a capital surplus over the minimum requirement for Core Tier 1 capital of 9% or 6% (under the baseline scenario and adverse scenario), 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 testing exercise on less granular data. 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.

### **6.3. Macroeconomic Scenarios**

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 (see Table 1). 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 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.

The adverse scenario is 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, 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.

#### **6.4. Basic calculation assumptions of the stress tests**

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 are 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, (derived from the residual maturity of liabilities until the end of 2015), 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.

## **6.5. Results of stress tests for the banking system**

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 2.

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 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.

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 (see Table 4).

#### **6.6. 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.

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 4. 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, 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?

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<sup>1</sup> For a comprehensive review of political, social, and economic development of Slovenia see »Slovenia – From Yugoslavia to the European Union«, The World Bank, 2004.

<sup>2</sup> 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.

<sup>3</sup> The preoccupation of Slovenian political leaders and people with the disintegration of Yugoslavia and creation of a new country also softened political tensions between the old and the new political elite and affected economic transition. While general public and many politicians were repeating the most popular slogan of the time of how “Slovenia was being badly exploited” in Yugoslavia, the government was calculating what are costs and benefits of independence. A reduction of the market; diminished supply of raw materials and of cheaper finished products from the rest of Yugoslavia; termination of foreign trade links which Slovenia had through Yugoslav companies and vice versa; a likely loss of property in other parts of Yugoslavia; and lessened interests of foreign investors for a small market were the liabilities of disintegration. It was also evident that the issues such as foreign debt, domestic debt denominated in foreign exchange, foreign exchange reserves, non-financial assets of the federation, 2500 different bi-and multilateral agreements on export quotas, transport licenses, air controls etc. might take years before being resolved. The benefits were more potential than actual; by independence Slovenia could avoid Yugoslav political turmoil, it would improve prospects of transition, enable proper economic policies, and eased entry into European Union. In fall 1990, potential benefits of Slovenia’s secession



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became higher than its economic and social costs, and independence became "the emergency exit" condition for democratic development and systemic transition.

<sup>4</sup> The splitting up of transition patterns to "shock therapy" and "gradualist" models hardly provides grounds for grouping of transition countries. First, the patterns of transition were rather chaotic mixtures of systemic changes and economic policies, some of which could be considered elements of a gradualist approach while others could be elements of a shock therapy. Secondly, what was a shock for one country, for example price and trade liberalization, was an element of a gradualist approach or even an element of the initial conditions in another country. What really mattered for the choice of tools and outcomes of transition were initial conditions.

<sup>5</sup> While former socialist countries' capabilities for successful transition differ considerably, they have all endured contraction of output which has surpassed "the macroeconomic stabilization" expectations. The disappearance of Leszek Balcerowicz's "pure socialist production" goods, the disruption in macroeconomic coordination mechanism, the inability to respond quickly to the shift from a sellers' to a buyers' market, the disintegration of the countries or/and trade associations, mistaken macroeconomic policies, and statistical overstatements are blamed for an enormous decline in measured output. Slovenia was, most likely, the least affected by the disruption in coordination and by transfer from the sellers' market towards a buyers' market. The coordination of the economy was for many years decentralized, the impacts of insufficient demand prevailed over those of supply shortages already in the eighties and the sole notion of "monetary overhang" was unknown.

<sup>6</sup> Exports surpass domestic private consumption, and exports to Germany alone surpass government consumption or investment demand. Furthermore, the demand pattern on the tiny domestic market differs substantially from the supply pattern fitted to the former Yugoslav market while the structure of sales to the former Yugoslav market much more resembled the export structure.

<sup>7</sup> Slovenia differed from other CEE countries by cautious approach to FDI in the form of acquisitions, and retained many non-financial and financial companies in domestic ownership.

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<sup>8</sup> Comparing Yugoslavia and EU has been considered indecent. However, one can simply not overlook the similarities. Let us start with heterogeneity in the level of development which causes problems both in having a proper economic system and in conducting proper economic policy which were the most important reasons why Slovenia decided to separate. The dialogue on what is democratic “one man, one vote” or “one state, one vote” is unavoidable as it was in former Yugoslavia. Finally, and what is most worrisome is what I label the “Yugoslav syndrome”. Namely, during the stagnation in the eighties, people began looking for who is to be blamed and who exploits them. At the end, each republic was “exploited” by all other republics. This is what seems to be appearing in EU. Yugoslavia survived a decade long stagnation before falling apart. Can EU and EMU survive a crisis which would last a decade? There are however some major differences between EU and Yugoslavia. The dissolution of Yugoslavia cannot be disentangled from transition from socialism, which at that time was at the brink of disappearance, while this is not yet the case with the existing financial capitalism in EU. Many people would say that Yugoslavia and EU are incomparable because of communist dictatorship in the former and democracy in EU. This is despite one party system in Yugoslavia only partially true; the country was open and, particularly in Slovenia, communist party became a rather liberal bureaucratic organization; nobody believed in communism and could easily adapt to any ideology. There is however an important economic difference between the two associations in favor of EU; economic convergence of newcomers before the crisis was rapid, while there was no convergence in Yugoslavia; GDP/capita in Slovenia was twice the Yugoslav average and seven times higher than in Kosovo both, in 1953 and in 1990.

<sup>9</sup> A rather predictable outcome of formal mass privatization has been unstable ownership structure made up of insiders, dispersed small owners, private and state owned financial institutions, and relatively few foreign owners. A sizeable portion of the economy has remained in direct or indirect state ownership. Formal privatization was followed by a slow gradual consolidation of ownership structure which however enabled political interference. While discretely used by previous governments, potential interference blew into full meddling

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with the government elected in 2004, despite its neo-liberal rhetoric of the “withdrawal of the state from the economy”.

<sup>10</sup> Author of the document “P2”, Jozse Mencinger, resigned from the post of the deputy prime minister in May 1991 due to disputes over privatization and became a member of the governing board of the new central bank.

<sup>11</sup> The possibility of future pegging would, according to the document, depend upon the existence of foreign exchange reserves and settlement of Yugoslav foreign and domestic debt issues.

<sup>12</sup> 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.

<sup>13</sup> Yugoslav federal constitution already in 1974 brought significant changes in the organization of the central banking system. The central banks of the republics were made responsible to its republican assemblies; their governors constituted the governing body of the National Bank of Yugoslavia and held veto power on its measures which therefore had to be accepted unanimously but implemented by republican central banks.

<sup>14</sup> According to the law the managing bodies of the Bank are the Governing Board and the Governor. The first Governing Board was composed of eleven members, whereof six external members were independent experts, proposed by the President of the Republic and appointed by the Parliament. The Governor appointed by the Parliament is President, the Deputy Governor and three Vice-Governors were members of the Governing Board. The Deputy Governor and Vice-Governors were appointed by the Parliament on proposal of the Governor. The external members of the Governing Board, the Governor, the Deputy Governor and Vice-Governors were appointed for a period of six years.

<sup>15</sup> The law also specifically stipulated that the Bank may not grant loans to the Republic of Slovenia higher than 5% of the annual budget or one-fifth of the anticipated budgetary deficit. These loans had to be repaid by the end of the fiscal year.

<sup>16</sup> Gradualism was consistent with soft changes occurring in the political sphere, the pillars of which can also be found in the process of pre-1989 democratization; gradualism implied

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that specific political, social, and economic features should be used. The fact that gradualism prevailed in macroeconomic policy and systemic restructuring does not imply that there was a general consensus. On the contrary; this became a disputed issue: the majority of domestic economists considered the legacy of the past an exploitable advantage; to many foreign and a minority of domestic economists, however, legacy would impede rather than assist the transition.

<sup>17</sup> 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.

<sup>18</sup> The BS prescribed detailed rules on the scope and method of consolidation for the purpose of fulfilling the obligations on a consolidated basis, for the calculation of capital: (concerning the valuation of items for calculating capital requirements and restrictions in relation to credit risk, market risk, operational risk, large exposures, investments in qualifying holdings outside the financial sector; the detailed rules on risk management, on the liquidity position, terms of reporting, criteria for adequate credit agencies and detailed rules concerning the internal capital adequacy assessment. For example: The bank's capital should never be lower than the minimum amount of share capital. The bank must assign each exposure depending on the level of risk associated with this exposure, choose risk weights of each exposure on the basis of: exposure category in which it is classified this exposure, and to examine the level of credit quality. The BS may determine the credit quality of individual exposure using credit rating, which was elaborated by external credit assessment institution. The BS recognize an ECAI as eligible if the evaluation methodology, which is used in accordance with the requirements of objectivity, independence, ongoing review and transparency, and if the ratings are the result of the assessment methodology in accordance with the standards credibility and transparency.

<sup>19</sup> Slovenia introduced Euro as the national currency on 1 January 2007. The transition to a new currency and the adjustment proceeded smoothly and quickly; there were some cases of prices being "rounded up", particularly in the service and catering sectors. 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

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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. This stimulated unprecedented lending and growth, resulted in high growth in imports, which was no more balanced with exports. With increased domestic spending, imports began to grow faster than exports, resulting in a significant increase of the external deficit. The current account deficit reached 4.9% of GDP in 2007, which was a clear indication of macroeconomic imbalances.

<sup>20</sup> This part of the paper is based on :

Report on comprehensive review of the banking system and associated measures, Bank of Slovenia, 28 pages;

Summary of decision on extraordinary measures imposed on Nova Ljubljanska Banka d.d. on December 18, 2013

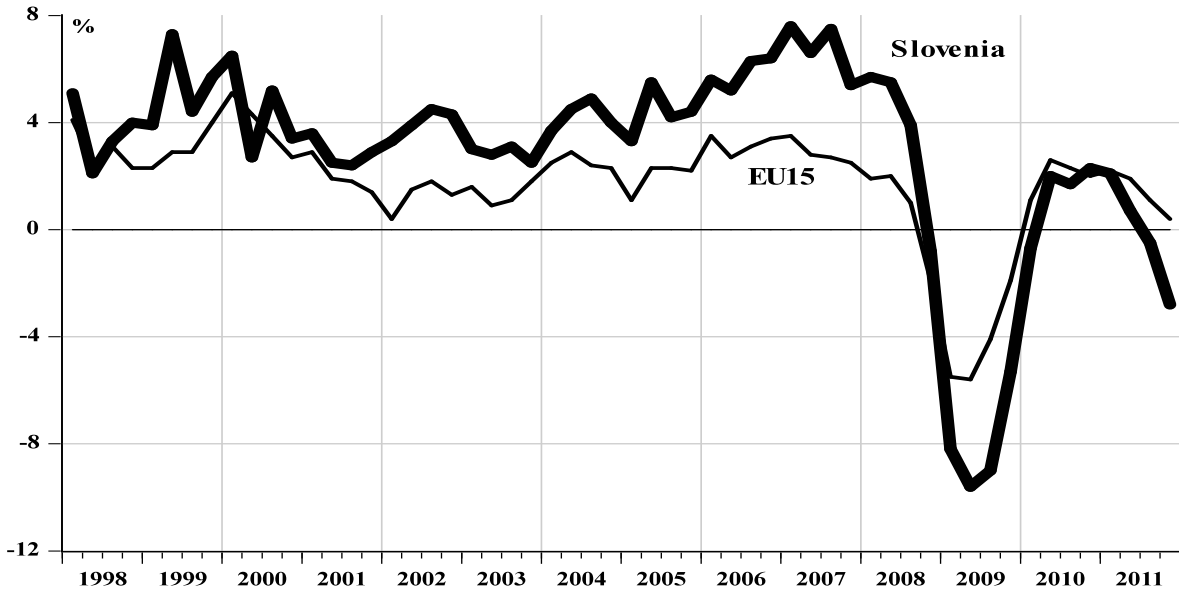
Summary of decision on extraordinary measures imposed on Factor Banka d.d. on December 18, 2013

Summary of decision on extraordinary measures imposed on Abanka Vipava d.d. on December 18, 2013

Summary of decision on extraordinary measures imposed on Nova kreditna banka Maribor d.d. on December 18, 2013

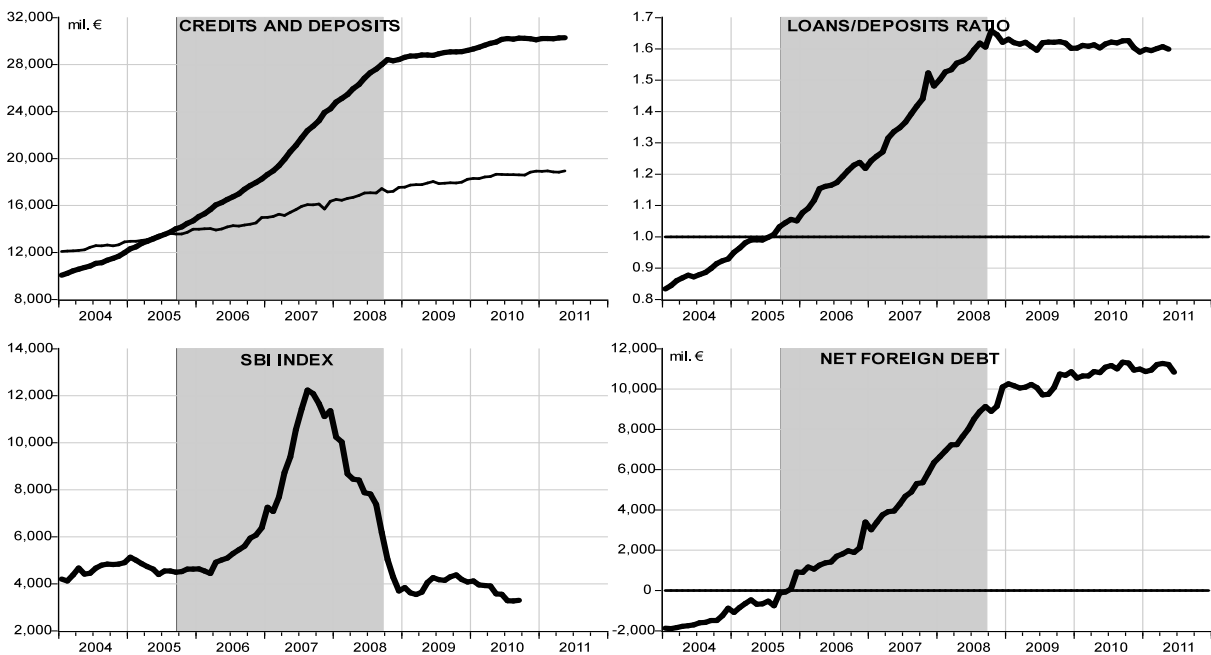
<sup>21</sup> Deloitte and Ernst & Young were selected to conduct the asset quality review, while several foreign real estate appraisers conducted the real estate valuations. The firms selected to conduct the stress tests were Oliver Wyman (bottom-up) and Roland Berger Strategy Consultants (top-down).

Graph 1. The dependence of Slovenia on EU (yearly growth rates of GDP 1998/I-2011/IV)



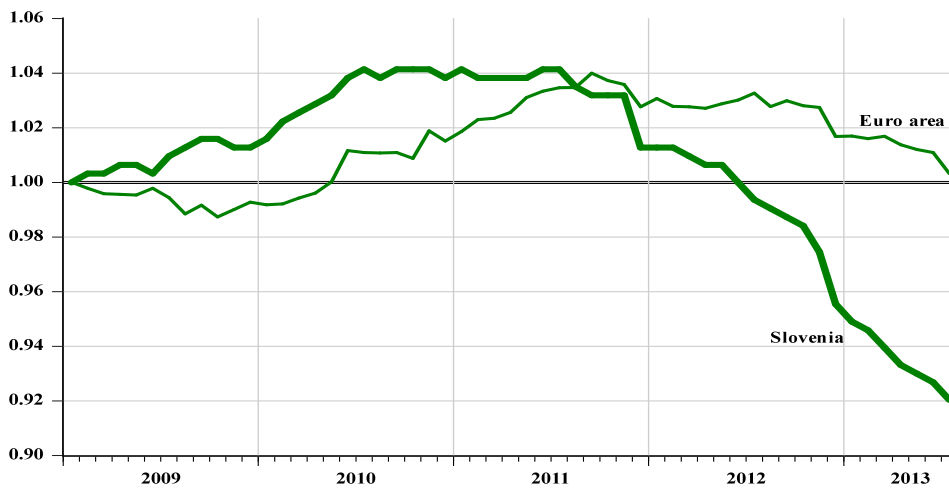
Source of data: Eurostat

Graph 2. Gambling (financial deepening, creation of virtual wealth and foreign indebtedness)



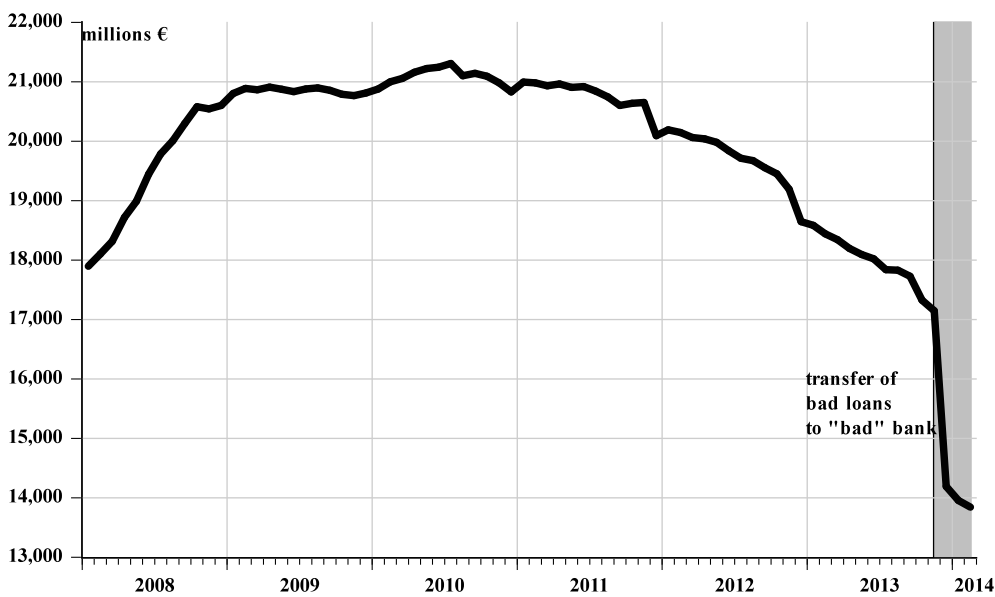
Source of data: Banka Slovenije and Ministry of finance

Graph 3. Credits in Slovenia and euro area



Source: ECB, own calculations

Graph 4. Credits to the non-financial business sector



Source: Bilten Banke Slovenije

Table 1. Macroeconomic scenarios for the stress tests (yearly growth if not indicated)

	2012A	2013	2014	2015	2013	2014	2015	2013
	actual	baseline scenario			adverse scenario			actual
GDP	-2.3	<b>-2.7</b>	-1.5	0.1	<b>-3.1</b>	-3.8	-2.9	<b>-1.1</b>
Private consumption	-2.9	<b>-4.8</b>	-3.5	-1.2	<b>-5.3</b>	-7.7	-6.5	<b>-2.7</b>
Gross fixed capital formation	-9.3	<b>-6.0</b>	-2.7	1.9	<b>-8.1</b>	-13.1	-3.6	<b>-2.5</b>
Net exports contribution	3.3	<b>2.6</b>	1.4	1.0	<b>2.9</b>	1.1	1.3	<b>1.3</b>
Employment	-1.3	<b>-2.6</b>	-1.4	-0.3	<b>-2.7</b>	-2.5	-1.8	<b>-2.2</b>
Unemployment rate (% of labor force)	8.9	<b>11.3</b>	11.5	11.5	<b>11.4</b>	12.6	14.0	<b>10.2</b>
EURIBOR (3m, in bps)	57	<b>25</b>	50	79	<b>58</b>	156	222	<b>25</b>
10 year government bond yields (in bps)	581	<b>602</b>	682	702	<b>638</b>	820	845	<b>340 (03/14)</b>
HICP	2.8	<b>1.9</b>	1.4	1.5	<b>1.8</b>	1.5	1.9	<b>1.8</b>
Residential house price	-8.2	<b>-9.6</b>	-4.3	-2.4	<b>-11.0</b>	-12.2	-7.1	<b>-6.0 (2012)</b>
Current account balance (% of GDP)	2.7	<b>5.0</b>	5.4	6.0	<b>5.3</b>	7.2	6.1	<b>7.1</b>
General government debt	54.1	<b>64.1</b>	66.2	69.6	<b>64.7</b>	71.5	84.0	<b>70</b>
Credit volume	-5.1	<b>-7.2</b>	-3.8	-1.9	<b>-7.5</b>	-6.5	-5.4	<b>-8.4*</b>
Deposit volume	-1.3	<b>1.0</b>	0.8	0.8	<b>0.6</b>	-0.5	-0.6	<b>-0.5</b>

Source: BS, own calculations



Table 2. Results of stress tests for the banking system

(in millions €)

		Projected economic losses	Absorption capacity	Capital shortfall		Difference
				baseline 9% capital ratio	adverse 6% capital ratio	
Top down	baseline	7369	4893	<b>2725</b>	<b>3280</b>	555
	adverse	8606	5326			
Bottom up	baseline	8889	4843	<b>4046</b>	<b>4778</b>	732
	adverse	10364	5586			
difference				<b>1321</b>	<b>1498</b>	

Source: BS Report

Table 3. Results of stress tests for eight banks

(in millions €)

	Baseline scenario		Adverse scenario	
	mil. €	% of assets	mil. €	% of assets
NLB	1643	11%	1904	13%
NKBM	887	17%	1055	20%
Abanka	646	18%	756	21%
Unicredit banka	23	1%	14	0.4%
Banka Celje	327	14%	388	17%
Hypo banka AA	189	10%	221	12%
Gorenjska banka	249	14%	328	18%
Reiffeisen banka	83	6%	113	8%
8 banks	4046		4779	

Source: BS Report

Table 4. Overall projected fiscal effects

(in millions €)

	Capital increase in cash	Capital increase in non-cash contribution	Capital increase Total
NLB	1.140	411	1.551
NKBM	619	251	870
Abanka	348	243	591
<b>Total</b>	<b>2.107</b>	<b>905</b>	<b>3.012</b>
Factor banka	160	109	269
Probanka	160	16	176
<b>Total</b>	<b>320</b>	<b>125</b>	<b>445</b>

Source: BS Report

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## **THE ABSTRACT OF THE PROJECT IS:**

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation? ; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived?'

## THE PARTNERS IN THE CONSORTIUM ARE:

Participant Number	Participant organisation name	Country
1 (Coordinator)	University of Leeds	UK
2	University of Siena	Italy
3	School of Oriental and African Studies	UK
4	Fondation Nationale des Sciences Politiques	France
5	Pour la Solidarite, Brussels	Belgium
6	Poznan University of Economics	Poland
7	Tallin University of Technology	Estonia
8	Berlin School of Economics and Law	Germany
9	Centre for Social Studies, University of Coimbra	Portugal
10	University of Pannonia, Veszprem	Hungary
11	National and Kapodistrian University of Athens	Greece
12	Middle East Technical University, Ankara	Turkey
13	Lund University	Sweden
14	University of Witwatersrand	South Africa
15	University of the Basque Country, Bilbao	Spain



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