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The Slovenian banking sector - Recent developments and future challenges

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Bucharest, 27 October 2017

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Main messages

- Favorable macroeconomic conditions in 2017 and favorable forecasts for 2018 – 2019.

- After seven years of contraction, credit growth is reviving and supported by eased conditions for credit supply and improved quality of credit demand due to deleveraging of the corporate sector and low indebtedness level of Slovenian households.

- Future challenges for Slovenian banks:

  - identifying new business models to achieve long-term adequate profitability in the low interest rate environment,
  - increase the attractiveness (and competitiveness) of banks' products for firms (digitalization and development of advanced technologies),
  - continuation of consolidation (and privatization) in the banking sector,
  - changing structure of banks' funding (increasing share of sight deposits).

Favorable macroeconomic environment

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- The Slovenian economy experienced one of the highest growth rates of all EA countries in 2016 (3.1%) and Q2 of 2017 (4.4%).
- Main factors supporting the business cycle:
  - growth in private consumption and private-sector investments sustained with an improved situation on the labor market and in the corporate sector,
  - the main risk for further growth is external environment.
- However, financial cycle recovery is lagging behind the business cycle.

Figure: Growth in quarterly GDP and value added by sector

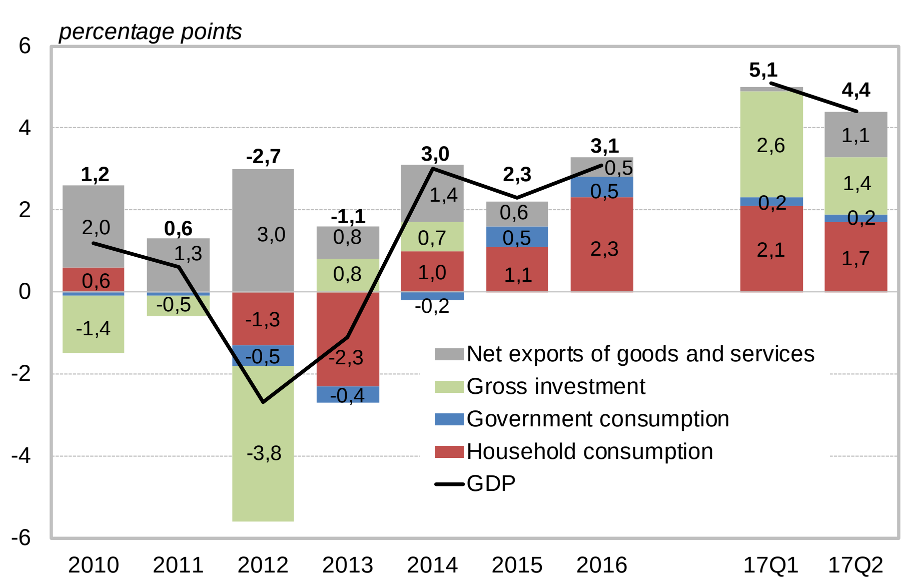
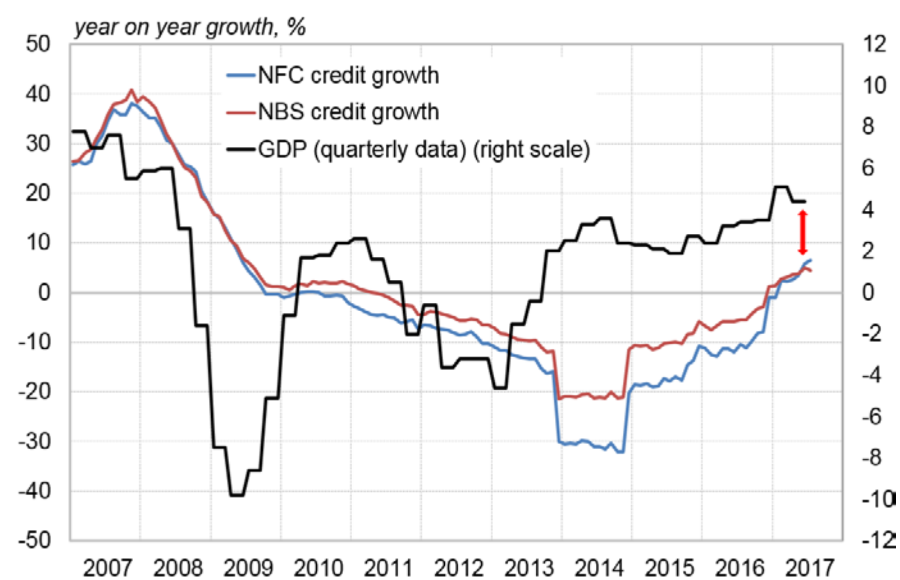


Figure: Growth in GDP and credit growth to NFC and NBS



Source: SORS; Bank of Slovenia

Improved situation on the labor market and increase in inflation

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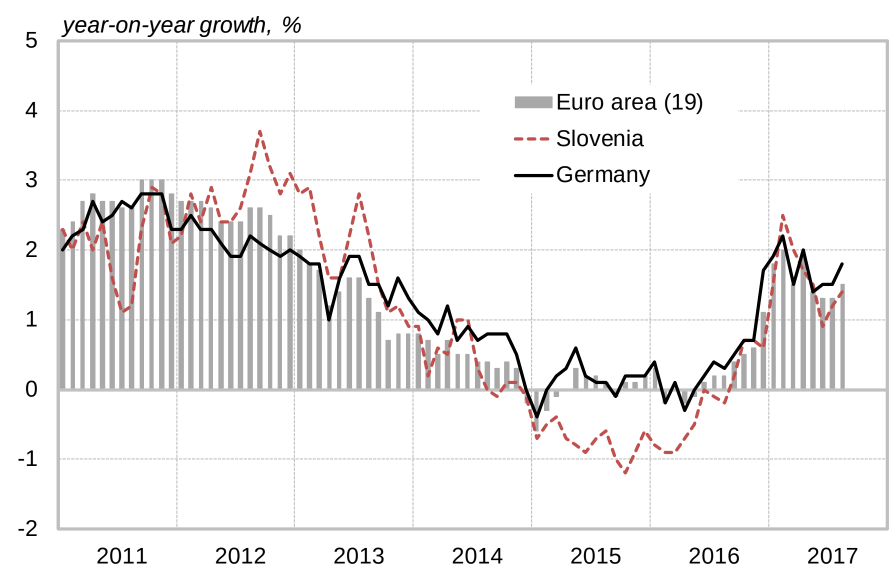
- Greatly improved labor market conditions:
  - unemployment has fallen sharply (from 10% in 2015 to 6.5% in the first half of 2017),
  - more pronounced growth in average gross wages,
  - and an increase in disposable income and net financial assets of HH together with low indebtedness level of Slovenian HH and also corporate sector, increase the potential for credit growth.
- Inflation rose in the second half of 2016 due to rising commodity prices, but inflation remains subdued in 2017.

Figure: Gross wages and unemployment rate

Figure: Inflation (HICP)



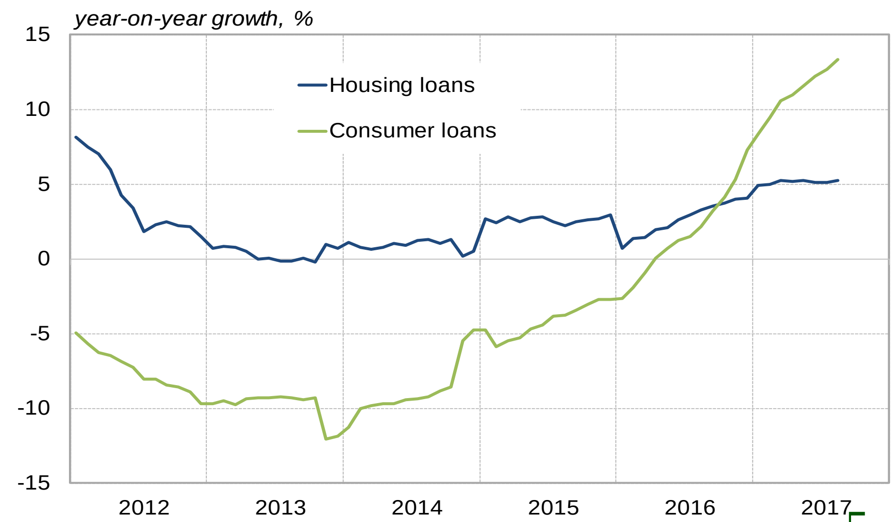
Source: SORS, Bank of Slovenia, Eurostat

Gradual revival of credit growth

- After seven years of contraction, the growth rate of loans to corporates turned positive in 2017:
  - low interest rates and improved conditions in the banking sector together with improved profitability and the low level of indebtedness of corporates started to translate to higher credit growth to corporate sector at the start of 2017.
- Credit growth of housing loans remained stable throughout the entire crisis period, while credit growth of consumer loans accelerated in 2017:
  - however, both are supported by the low indebtedness level of HH, improved conditions on the labor market and on the real estate market.
- Only gradual growth of credits to NFC is expected, due to increasing share of financing from the rest of the world (important alternative) and from the retained profits.

Figure: Loans to corporates

Figure: Loans to households



Source: Bank of Slovenia

Corporates repaired their balance sheets during the crisis

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- Eight consecutive years of adjustments in indebtedness of corporate sector:
  - debt-to-equity ratio declined by 40 p.p. from 146% in 2008 to 106% in 2016 and is now comparable to the EA median,
  - the decline in the debt-to-equity ratio is based on a reduction in liabilities and less on an increase in equity,
  - the level of debt-to-GDP in Slovenia is at 103% in Q1 2017; is below EA median.
- The corporate investment rate increases and with the continuation of favorable economic conditions, we expect further growth.

Figure: Non-financial corporations debt-to-equity ratio

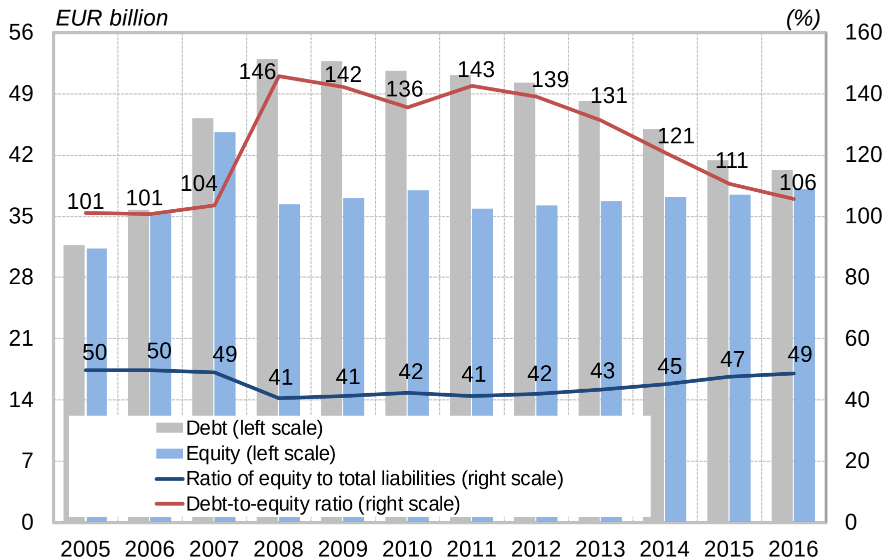
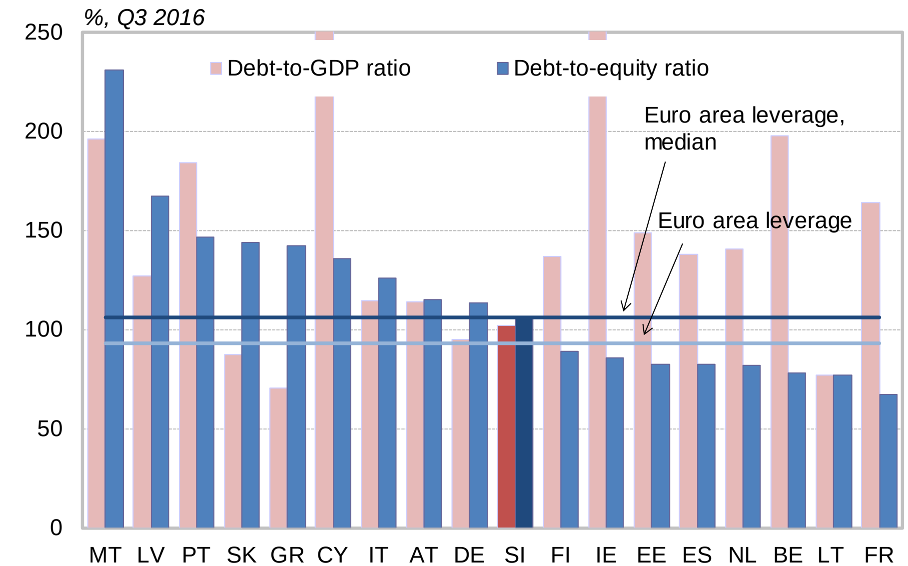


Figure: International comparison of corporate indebtedness in EA



Source: Bank of Slovenia

Quality of credit portfolio is improving

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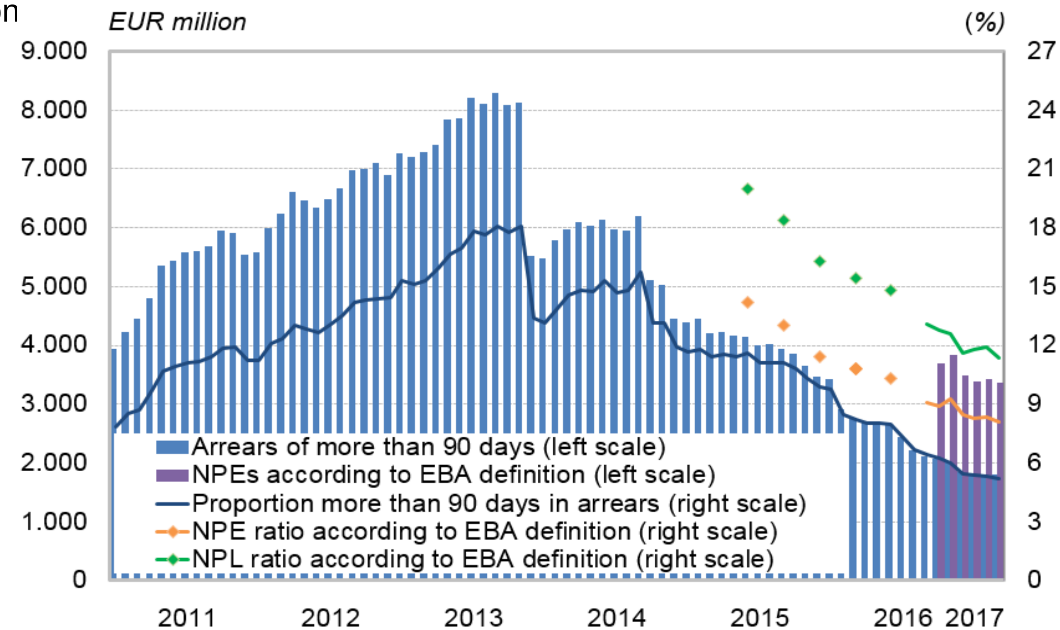
- After the rehabilitation process of the Slovenian banking system in 2013, credit risk has been consistently declining, measured both in terms of CC in arrears above 90 days as well as by NPE:
  - the proportion of CC in arrears above 90 days decreased from 18% in 2013 to 5% in 2017,
  - non-performing exposures by EBA definition reduced from 14.2% in 2015 to 7.5% in 2017.
- After 2013, Slovenian banks applied a more active approach in resolving bad claims:
  - expanded sales of NPLs, asset transfer to BAMC, write-offs, collateral liquidation, activities in resolving NPLs in SMEs.

Figure: Classified claims more than 90 days in arrears, NPEs and NPLs according to EBA definition



Source: Bank of Slovenia

Changing structure of banks' funding

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- LIRE impacts on changing structure of banks' funding:
  - increase of NBS deposits by more than 28 p.p. from crisis period to 70.4% of total liabilities,
  - decrease of wholesale funding by more than 27 p.p. from crisis period to 9.2% of total liabilities.
- Funding risk remains low, but the stability of NBS deposits is under threat due to the increasing share of sight deposits in total liabilities:
  - share of sight deposits in HH deposits at almost 70% in August 2017,
  - NBS sight deposits, especially sight deposits from NFC (at 66%) more sensitive to external shocks.

Figure: Breakdown of bank funding

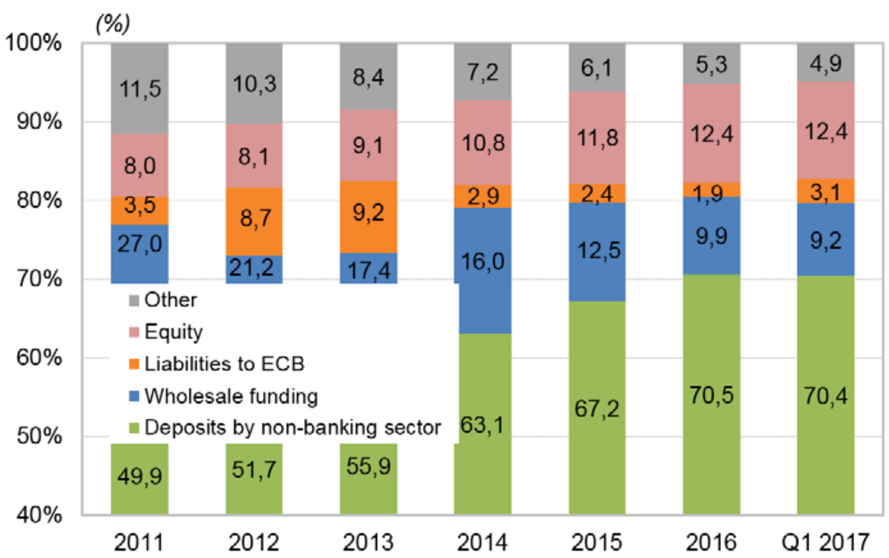
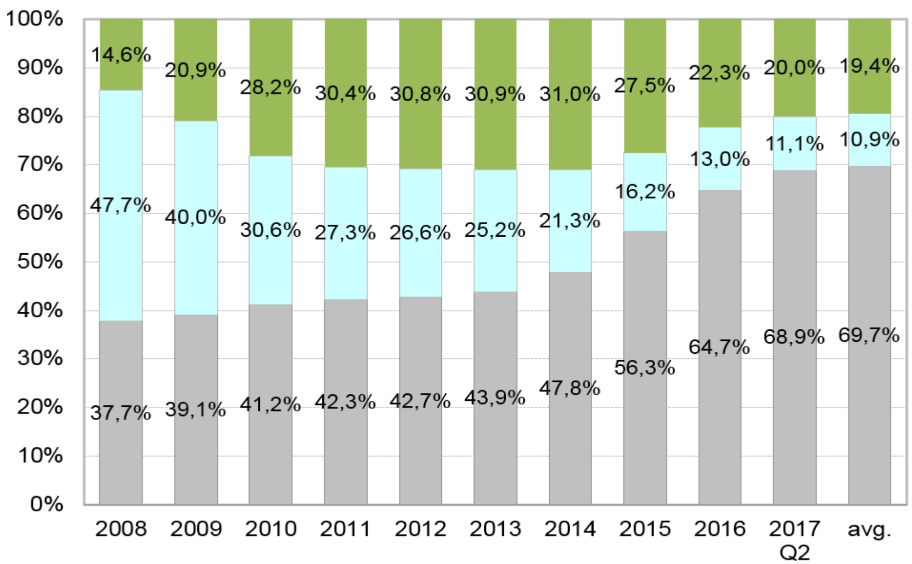


Figure: Structure of HH deposits by maturity



Source: Bank of Slovenia

Shortening maturity of NBS deposits and lengthening maturity of loans

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- The growing proportion of sight deposits and approval of long term loans in total balance sheets increase the maturity mismatch:
  - the average maturity of corporate loans lengths. Also, the average maturity of households loans lengths as a result of intensive approvals of housing loans.

Figure: Average repricing period for asset and liability interest rates, in months

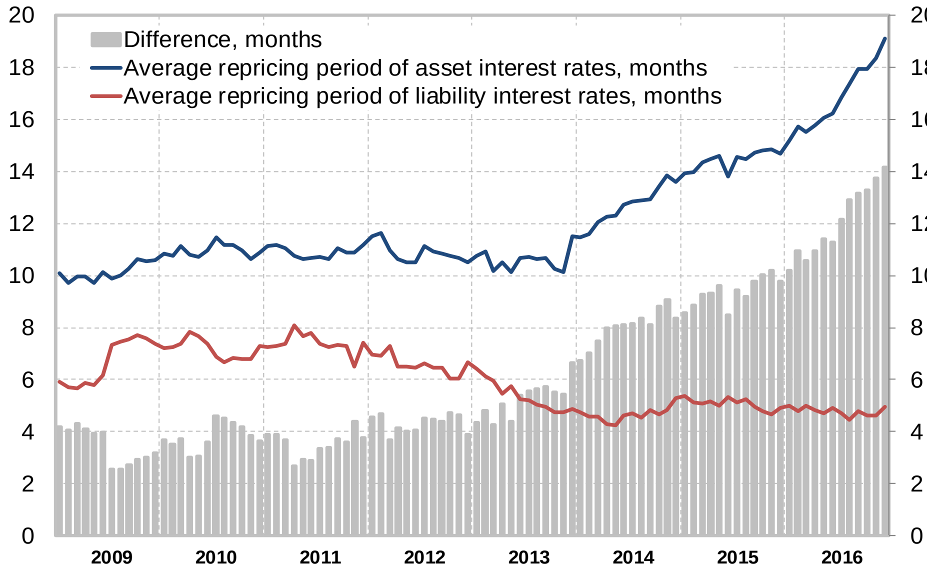
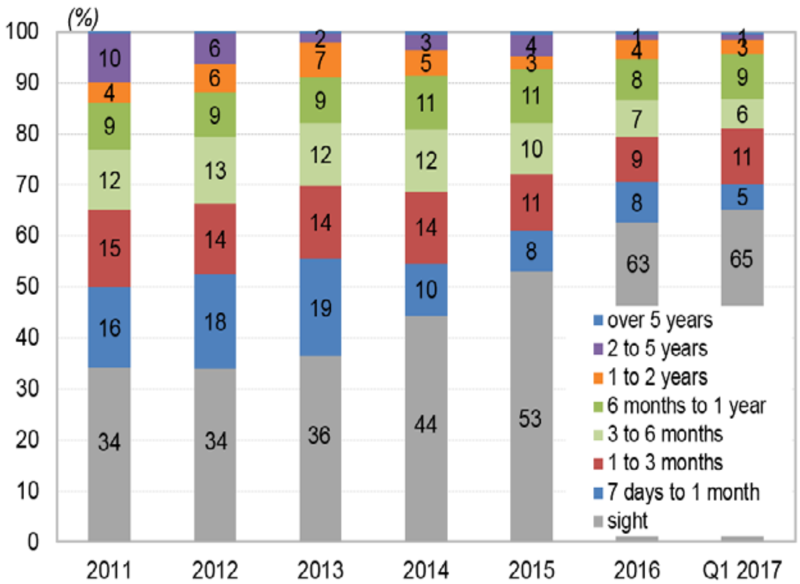


Figure: Breakdown of deposits by non-banking sector by repricing period



Source: Bank of Slovenia

Banks maintain high share of liquid assets

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- The new circumstances increase the stock of liquid assets on banks' balance sheets:
  - secondary liquidity as mitigation factor for potential liquidity shock is relatively high: at 19.8% in August 2017,
  - banks are decreasing exposure to Slovenian government securities.
- Banks maintain high level of liquidity coefficients KL1 and KL2 at 1.42 and 1.23, respectively in August 2017, but they are gradually decreasing.

Figure: Stock of marketable secondary liquidity

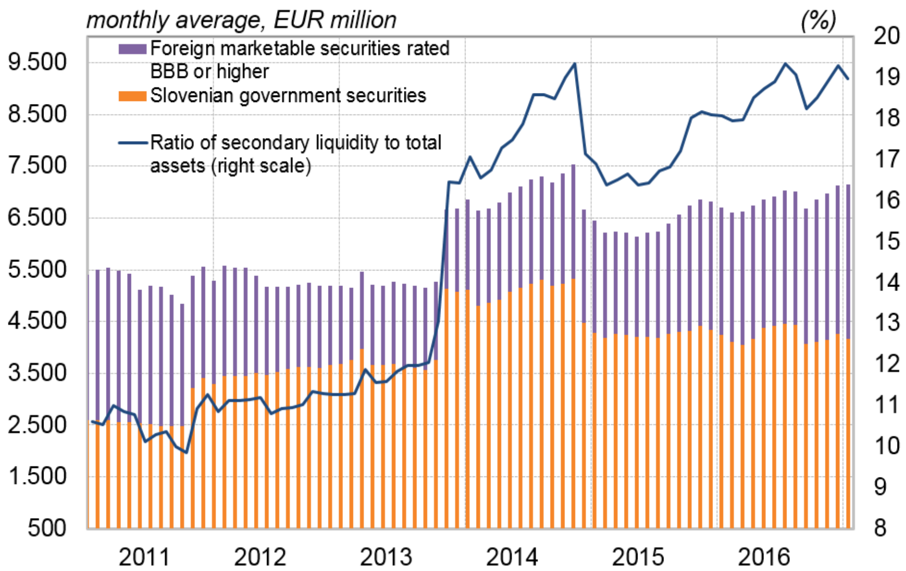
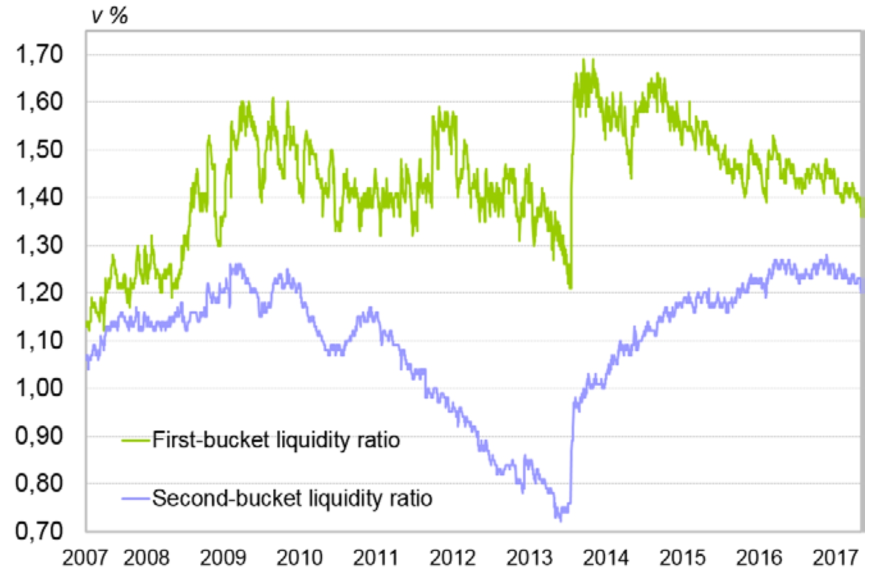


Figure: Daily liquidity ratios for the first and second buckets of the liquidity ladder



Source: Bank of Slovenia

Profitability is improving, but on the long-term income risk could increase

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- Slovenian banks improved profitability in the last two years:
  - Decreasing costs of impairments and provisions.
  - Revived credit growth yet to have positive impact on interest income.
- However, income risk on the long-term could increase:
  - In LIRE banks still facing a decline in interest income.
  - The pressure on NIM remains.
  - Needs for further adjustment of banks' business models.

Figure: Year on year growth rates, in %

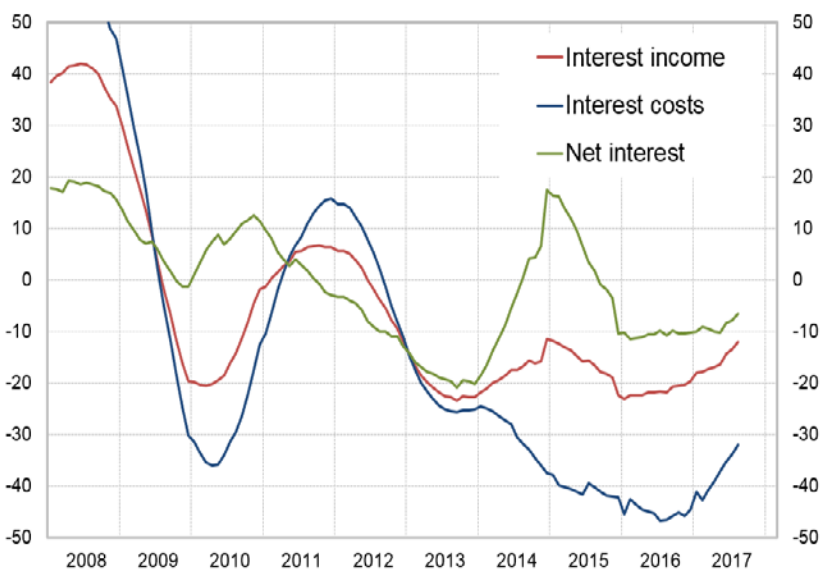
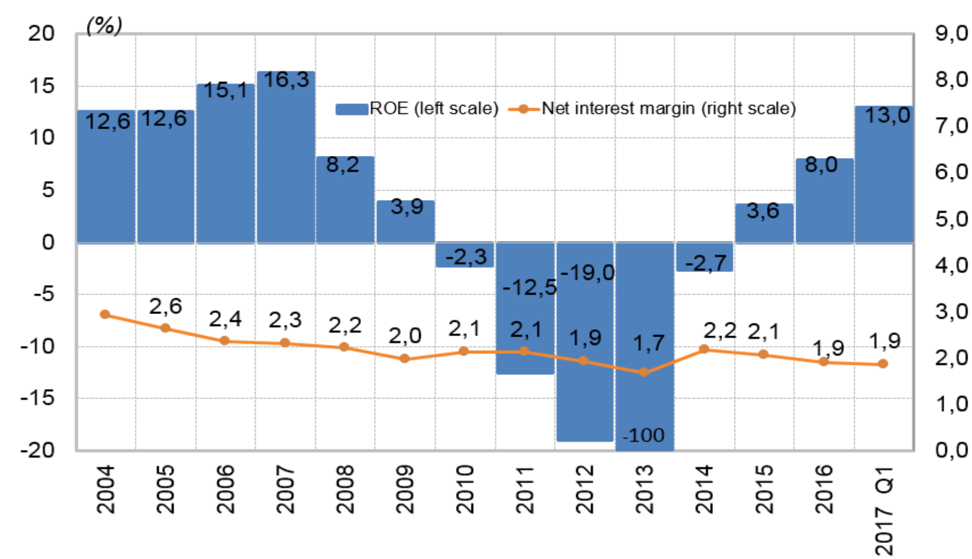


Figure: NIM on interest bearing assets, and ROE in the Slovenian banking system



Source: Bank of Slovenia

Capital adequacy ratio

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CAR increased by 0.5 p.p. in 2016 on consolidated basis to 19.1%, CET1 ratio increased by 0.5 p.p. to 18.5%.

- RWA decreased by 0.3% (restructuring).
- Own funds decreased by 0.4% (decrease of subordinate instrument).
- Despite the increase, the CAR of small domestic banks remains bellow the average of the EA (solo CAR 14.1%, Capital/Total assets 5.7%).

In the LIRE environment and due to increase of profitability risk, the retained profit of banks could be insufficient be to support adequate CAR.

Figure: Capital adequacy ratio on consolidated level in %

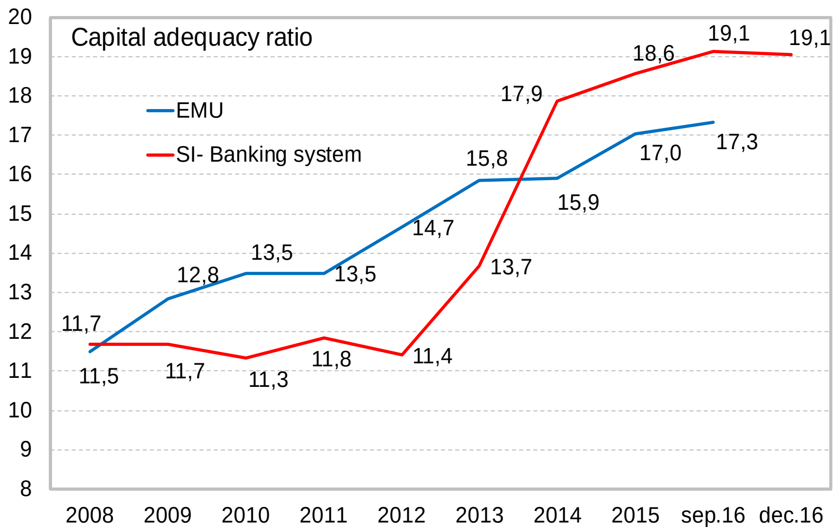
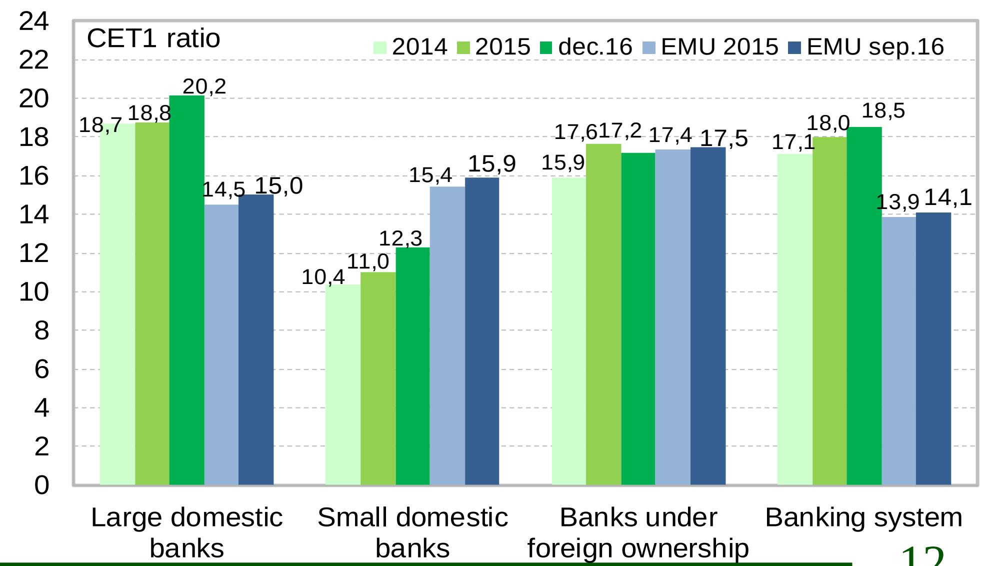


Figure: CET1 by banking group in comparison to EMU (cons.) in%



Source: Bank of Slovenia

Future challenges for Slovenian banks

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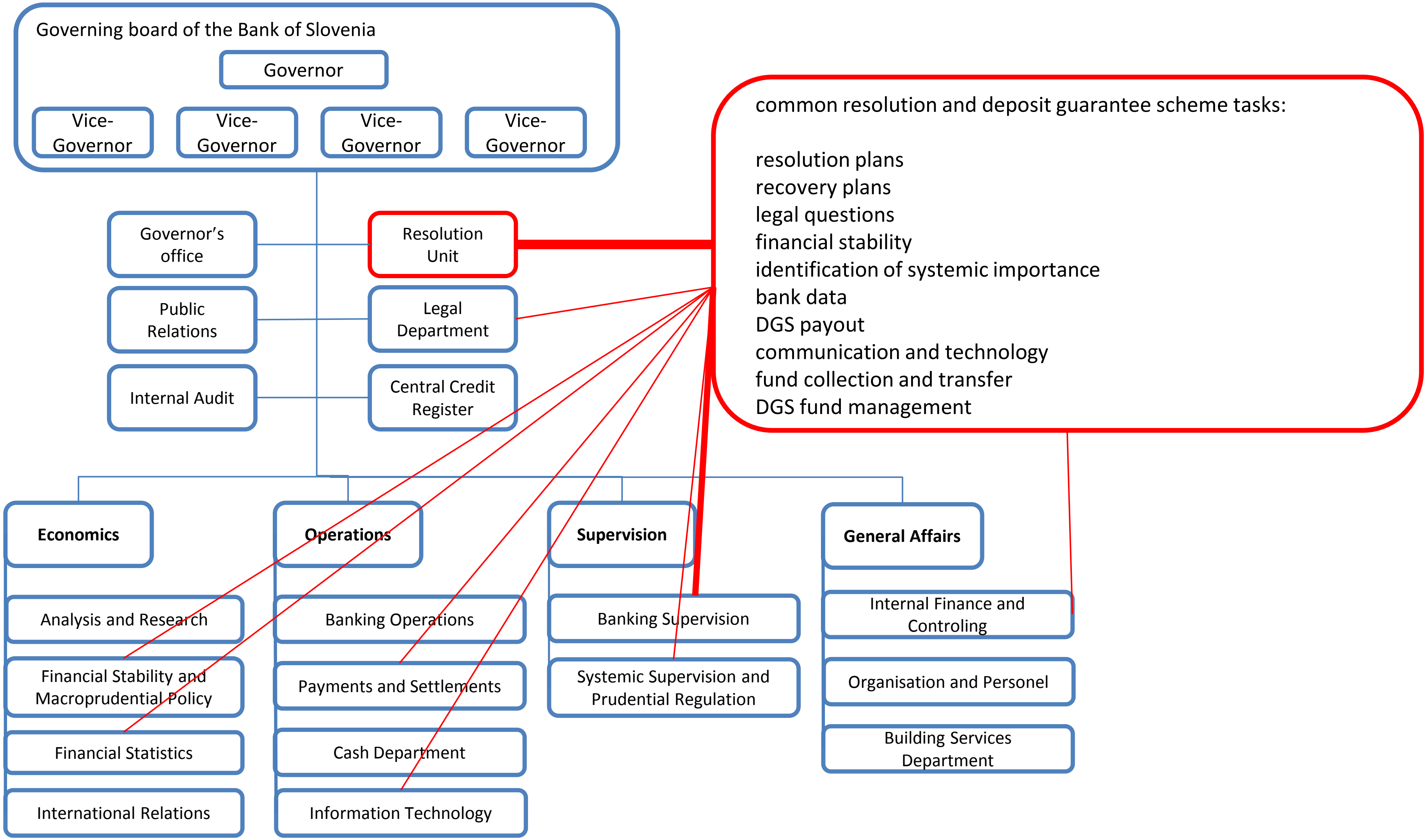
- In Slovenia, the process of consolidation and the concentration of the banking system has been present since the 90's:
    - From 36 commercial banks in 1994 -> 24 commercial banks in 2008 -> 15 commercial banks in 2016.
- One factor determining the banks' successful performance will be their ability to adjust their business models to seek better returns while optimizing risk take-up:
    - the banks are adjusting their business models in the direction of an increasing proportion of net non-interest income,
    - the banks' earnings in the coming years will depend primarily on turnover, developments in interest rates, sustained credit growth and credit risk parameters,
    - banks will need to focus more on additional sources of non-interest income, further introduction of advanced technologies and digitalization.
- Revived credit growth yet to have positive impacts on credit portfolio quality and interest income.
- The rising proportion of sight deposits continues to entail risks in the event of unforeseen external shocks.
- Improved financial position of NFC, a low indebtedness level and an improved income position of HH together with favorable economic forecasts establish the conditions for the beginning of a new credit cycle.

Resolution Unit in the Bank of Slovenia



Cooperation with Single Resolution Board

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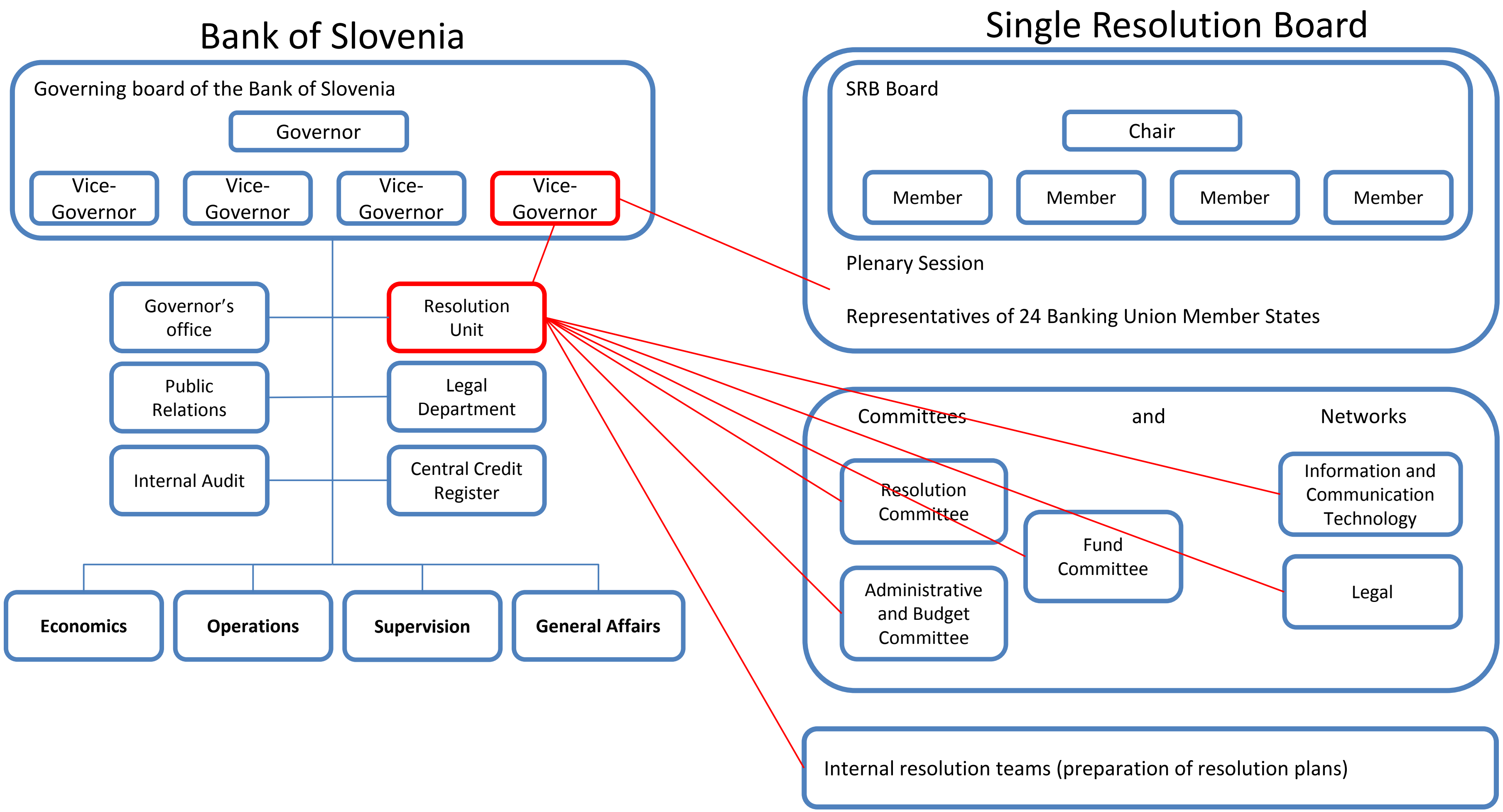

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