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Rehabilitation of the Slovenian Banking System: Seeking Strength in the Aftermath of Crisis

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Introduction

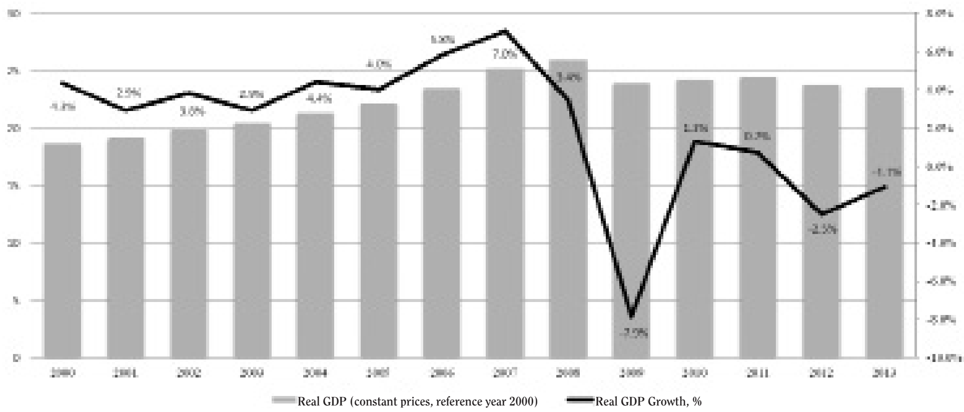
Fiscal imbalances, a shrinking economy, and severe problems with its banking system plunged Slovenia into the largest financial crisis in its history. The problems in the country's banking system are closely related to Slovenia's past: banks issued billions of euros in loans with relaxed lending standards during times of financial prosperity and economic stability. These loans were granted because there were no immediate signs of the ensuing economic strife such deals would later spark. The most severe problems plague state-owned banks, which hold the largest market share in Slovenia's banking system, and continue to prevent Slovenia's economy from stabilizing. In stimulating the economy and breaking free of a double-dip recession, Slovenian banks must continue to revitalize lending while strictly adhering to proper due diligence practices, a process that requires both banking sector and corporate sector restructuring.

Prior to the dawn of the world financial crisis, the Slovenian economy was among the fastest growing economies in the euro area. Problems began soon after 2008 as the wave of the U.S.'s financial crisis began to have an impact on Europe. While all European countries were affected, the crisis affected Slovenia more significantly as billions of euros in defaulted loans plagued the Slovenian banking sector. Slovenia experienced a double-dip recession with real GDP falling over 9.5 percent from the onset of the country's financial instability in mid-2008 to late 2013. As seen in Figure 1, stagnant and negative economic trends have restrained GDP growth over the 2006–2013 time period, essentially making the past seven years "lost" in terms of economic strength (Statistical Office…). With negative trends in employment and domestic consumption, rising government debt, and rising inflation, Slovenia's GDP further contracted by 1.1 percent in 2013.

As evidenced by a severe decline in GDP

Figure 1

Slovenia's Real GDP (€Billion) and GDP Growth: 2000–2013



Note: Data before 2007 are recalculated using the fixed exchange rate between tolar and euro (239.64 tolars for 1 euro).
Source: Statistical Office of the Republic of Slovenia.

over the 2008–2009 period, shown in Figure 1, Slovenia was not prepared to weather the world's growing economic crisis. Banking sector structural weaknesses pushed the nation to its financial tipping point and brought it close to needing international funds to repair the economy. In an attempt to avert such bailout funds, Slovenia continues to introduce stability and reform programs driven by the government's own resources: capital reserves, issuance of sovereign securities, state-owned bank and firm privatizations, and tightened banking sector regulation. To ensure financial stability, Slovenia must recapitalize and restructure its burdened banking sector.

Slovenian Banking Environment

This article focuses on Slovenia's three largest banks in which the Slovenian government owned significant participating interest at the outset of the country's financial crisis: Nova Ljubljanska Banka (NLB), Nova Kreditna Banka Maribor (NKBM), and Abanka Vipa (Abanka). NLB, NKBM, and Abanka are the most important Slovenian banks to analyze for three reasons. First, these three banks owned a combined total asset market share in Slovenia of 38.5 percent in 2013 and thus have a substantial impact on Slovenia's economy, an impact that was more pronounced with significantly higher market shares at the outset of the financial crisis. Second, state-owned banks in Slovenia were more adversely affected by the world financial crisis than foreign-owned private banks, because the latter banks followed strict governance standards from their foreign mother banks and were more prudent in extending loans (e.g., following proper loan due diligence). Third, foreign-owned banks have proved less problematic to the Slovenian government than state-owned banks because foreign mother banks are primarily responsible for their banks' recapitalization and rehabilitation (NLB; Nova KBM; Abanka).

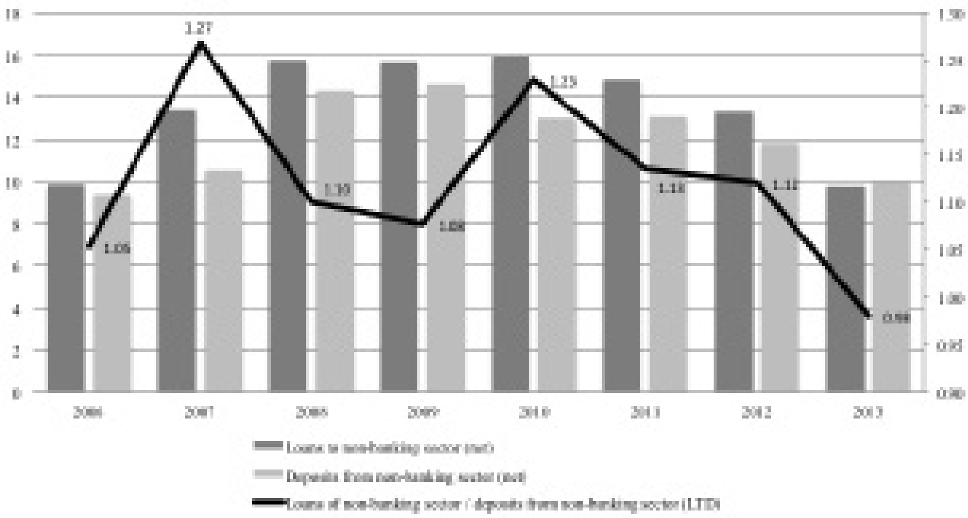
Overview of Slovenian Banking Sector

The highly leveraged economic growth in Slovenia was an unsustainable situation. Plagued by the world financial crisis beginning in late 2008, credit growth[1] from the Slovenian banking sector to the private sector stagnated (see "Loans to non-banking sector (net)" in Figure 2) and experienced negative growth over the 2010–2013 period. The world financial

[1]Credit growth refers to an increase in loans to the non-banking sector.

Figure 2

Total Combined Loans and Deposits (€Billion) of NLB, NKBM, and Abanka



Sources: Abanka; NLB; Nova KBM.

crisis ended a period of high-growth bank lending in Slovenia that had relied heavily on borrowed funds from foreign financial institutions. Facing uncertain international financial market performance, downgraded sovereign debt, and a weakened banking sector, Slovenian bank funding has steadily deteriorated since the onset of the world financial crisis (BOS, "Report on Comprehensive…").

Slovenian banks have operated at a loss over the 2010–2013 period, which has severely diminished banks' capital adequacies. Banks under majority state ownership, including NLB, NKBM, and Abanka, have been particularly affected. The adverse affect of operating losses on capital adequacy has led to reduced capital requirements and stagnated lending activities. Despite lowered capital requirements, Slovenian banks' capital adequacy ratios remain below those of comparable banks within the euro area (BOS, "Report on Comprehensive…").

Banking Sector Decline

Banks make money by granting loans and collecting fees and interest as a result of these loan transactions. If borrowers do not service their loans,[2] as in the case of Slovenia, then banks are not profitable. Additionally, the sources of banks' loanable funds are deposits and the interbank market.[3] Profitable banks gain from the margin between the interest rates at which they are borrowing from depositors and the interbank market and rates at which they are lending to borrowers. Slovenian banks faced high risk due to maturity mismatch[4] because interbank credit is historically short term whereas loans that Slovenian banks issued to the private sector over the past two decades were typically long term.

After 2008, as the world plunged further into a deep financial crisis, the interbank credit market dried up. Slovenian banks, which were borrowing in the interbank market, found

[2]Banks service loans by collecting payments from a borrower that consist of original principal and interest payment on the outstanding loan amount. Borrowers, in this case enterprises, service loans by making payments.

[3]The interbank market is a market in which banks lend to one another.

[4]Maturity mismatch refers to a firm's short-term liabilities outweighing its short-term assets. A bank's liabilities are deposits, and its assets are loaned funds.

Table 1

Ratios of Non-Performing Loans to Total Loans of NLB, NKBM, and Abanka

% Values	2007	2008	2009	2010	2011	2012	2013
NLB	1.7	2.5	4.5	10.5	17.9	26.0	20.4
NKBM	3.5	2.2	5.9	9.2	12.1	16.9	25.5
Abanka	2.0	2.4	3.7	10.9	16.5	25.7	46.1

Sources: Abanka; NLB; Nova KBM.

that when loans came due they were not being renewed. Since no new money was coming in, banks increased the terms of their lending to enterprises, thereby increasing interest costs to lend and shortening the maturity structures of these loans. Thus, enterprises that borrowed money from Slovenian banks found that as loans came due for payment, banks did not want to renew them. Enterprises interested in investing do not have many long-term loan options, and the loans that are available have become prohibitively expensive. Thus, certain investments are not viable for enterprises given the current banking sector situation in Slovenia. With insufficient available capital to invest in continued operations and development, Slovenian enterprise growth has stagnated and inhibited economic growth.

To add to the hardship the Slovenian banking sector faced, banks did not follow appropriate due diligence practices. In other words, there was no proper credit approval process. When banking activity slowed down, enterprises found it more difficult to service loans and ran into arrears[5] with Slovenian banks. Thus, the Slovenian banking system found that many of the loans became toxic (i.e., non-performing). When loans become non-performing, banks must include loan loss provisions and tighten credit standards. Slovenian banks first tightened credit because the supply was down and then further tightened credit because the loans that they did grant were not being serviced by the enterprise sector. At the outset of 2014, Slovenia was in a "credit crunch"—banks have not been lending to enterprises and economic growth has suffered as a result (Banerjee).

The Problem of Non-Performing Loans

According to the European Banking Authority, non-performing loans (NPLs) are categorized as loans that have been granted to borrowers rated D and E as well as loans that have been in default for more than 90 days (BOS, "Report on Comprehensive…"). The metric given by a bank's NPL value divided by total loan value, shown in Figure 3, is a financial soundness indicator used as a proxy for asset quality. There are four ways that distressed countries handle NPLs: 1) sell them on the open market, 2) restructure them, 3) hold them, or 4) establish a "bad bank" that will absorb these "bad" assets to clean the country's banks' balance sheets (Ernst & Young). With 26.1 percent of all three banks' total loan value deemed non-performing in 2013 (note the mostly upward trend of NPLs for NLB, NKBM, and Abanka in Table 1), there remains significant work to be done.

An NPL Example: Nova Ljubjanska Banka[6]

NLB, Slovenia's largest bank, which was more than 90 percent directly or indirectly owned by the government pre-privatization, is in the process of correcting a troubling

[5]The term *arrears* refers to the amount of overdue payments a borrower has accrued from missed loan payments.

[6]This section is intended to briefly illustrate the issue of NPLs within Slovenian banks and in doing so simplifies NLB's financial structure.

Table 2

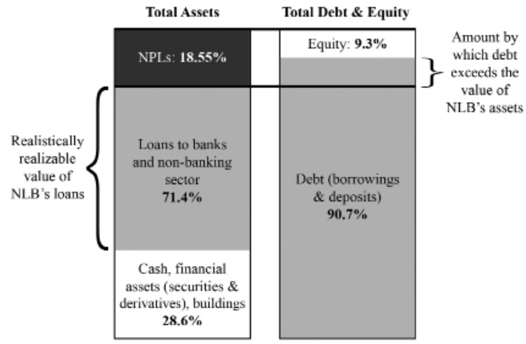
NLB's 2012 Balance Sheet

	€Million (Except %)
Total assets	11,487.0
Customer loans	8,197.7
Total liabilities	10,420.0
Total equity	1,067.0
NPL/total loan ratio	26.0%

Source: NLB.

Figure 3

NLB's 2012 Balance Sheet



Source: NLB.

situation: the combined value of debt (borrowings and deposits) and equity (from the bank's shareholders) grossly exceeds the amount of non-toxic assets on its balance sheet ("Market Shares of Biggest…"). From NLB's simplified 2012 balance sheet (Table 2), it is evident that customer loans (loans to banks and the non-banking sector that are assets on a bank's balance sheet) are the majority of NLB's total assets. Although a high percentage of customer loans as a percentage of a bank's total assets is normal across banks worldwide, NLB possesses an extremely high NPL/total loan ratio of 26.0 percent. The high percentage of NPLs in Slovenia, fueled by lenient lending practices and sub-par capital adequacy requirements, has devastated the Slovenian economy.

As a concrete example, a simplified version of NLB's 2012 balance sheet[7] illustrates Slovenia's problem. NLB's €8,197.7 million in loans to banks and the non-banking sector (customer loans) account for 71.4 percent of NLB's 2012 total assets of €11,487.0 million. The remaining 28.6 percent of total assets include cash, financial assets such as securities and derivatives, property and equipment, intangible assets, and other investments. On the other side of NLB's balance sheet, total liabilities (or debt) of €10,420.0 million account for 90.7 percent of total debt plus equity while equity accounts for the remaining 9.3 percent. The problem lies in the NPLs, the bad assets. At the end of 2012, NLB had an NLP/total loan ratio of 26.0 percent. This ratio translates to a total NPL value of €2,131.4 million or 18.55 percent of NLB's total assets (NLB). NPLs have shrunk the realistically realizable value of NLB's loans, thereby forming a significant gap between the bank's assets and debt and signaling the need for government action.

Rehabilitation Initiatives for Slovenia's Banking System

Three major catalysts have fueled Slovenia's current banking sector predicament: excessive lending without proper due diligence practices, the global economic crisis, and a lack of adherence to capital adequacy requirements as required by the Bank of Slovenia (BOS) and EU banking regulations.

While doomsday speculations have calmed, there remains significant work to be done:

1) Hastened privatization of state-owned banks and other institutions that would improve operational efficiency through privatization
2) Strengthening of banking supervision at the bank management and EU levels
3) The transfer of burdening NPLs on the balance sheets of Slovenian banks to the government-run Bank Asset Management Company (BAMC)
4)Strict compliance with BOS and EU banking regulations
5) Regular independent asset quality reviews (AQRs)

[7]In its most simple form, a balance sheet unveils a firm's financial position by detailing the values of a firm's assets, liabilities, and equity capital at a given time.

Slovenia's banks and government have made steady strides in alleviating the current stresses of the deteriorating economy and failing banking system. The following sections detail these efforts.

Privatization

The government of the Republic of Slovenia is currently moving to divest its non-strategic stakes and holdings in banks and other companies. The government has adopted the "Privatization Programme," under which it will privatize 15 firms (Petra). With specific regard to the country's banking sector, the Slovenian government is taking steps to reduce its participating interest in NLB to no more than 25 percent and sell off its entire participating interest in NKBM (BOS, "Bank of Slovenia…"). Selling state-owned companies to the private sector will generate capital to help pay down government debt. Additionally, a reduction of the government's participating interest in NLB, NKBM, and Abanka will likely improve management of the country's banking sector.

BAMC Formation and Recapitalization

Measures taken to strengthen Slovenian banks include 1) a comprehensive review of the banking system; 2) an immediate capital increase at NLB, NKBM, and Abanka (Table 3); 3) required burden-sharing on behalf of bank shareholders; 4) the transfer of NPLs to the BAMC; 5) capital increases for Slovenian banks; 6) a guarantee by the Slovenian government to provide requisite capital as a lender of last resort; and 7) future BOS responsibilities, including the implementation of regular bank stress tests.

In the first phase of bank restructuring, Slovenian banks needed to determine how insufficient their reserves and equity (e.g., loan loss provisions) were in covering the face value of these NPLs. As expected, Slovenian banks faced an overwhelming lack of sufficient funds, and the government prepared to recapitalize these troubled banks.

Transferring "assets" of bad loans to a bad bank at a steep discount from the original value of these loans will clean the balance sheets of Slovenian banks that are burdened with NPLs. Created in October 2012, the BAMC is a much delayed government program enacted to relieve Slovenian banks of €4.778 billion in bad loans. The BAMC will focus on dealing with the bad loans it absorbs, thereby freeing the relieved banks to focus on regular operations (OECD). The amount of bad assets transferred to the BAMC will be replaced with government equity on banks' balance sheets.

The BOS and the Ministry of Finance, along with observers from the European Commission, European Central Bank (ECB), and European Banking Authority, conducted a comprehensive review of Slovenia's banking sector over a five-month period, August 2013 to December 2013. The comprehensive review analyzed the quality of assets on Slovenian banks' balance sheets and subjected the banks to stress tests that analyzed the robustness of the Slovenian banking sector under adverse economic scenarios over a time horizon of three years, 2013 to 2015. Regulators determined that the capital deficit of the Slovenian-banking sector totaled €4.778 billion and the immediate capital needed to stabilize Slovenia's three largest, state-owned banks totaled €3.012 billion (Table 4) (BOS, "Bank of Slovenia…").

The stress tests of the Slovenian-banking sector conducted in late 2013 proved Slovenia's ability to recover without external bailout funds. Under mounting pressure from the ECB,[8] Slovenia has been working to swiftly recapitalize distressed yet viable Slovenian banks and swiftly liquidate insolvent ones. Even prior to Slovenia's comprehensive banking sector review, NLB, NKBM, and Abanka failed to meet the BOS's capital requirements. Capital requirements are important because a strong capital base allows banks to comfortably offset losses without needing to seek assistance from the Slovenian government or foreign financial institutions. The capital serves as a financial buffer in times of economic turmoil. It allows the bank to avail itself of credit facilities to its clients even when financial supplies are low. In general, higher capital bases translate to stronger balance sheets.

[8]The ECB is the central bank for Europe's main currency: the euro. The ECB aims to maintain the euro's purchasing power and ensure European financial stability.

Table 3

Sources of Capital Increases for NLB, NKBM, and Abanka

	Total Capital Increase, €Million	Capital Increase via Cash	Capital Increase via Sovereign Securities	Write-down of Subordinated Instruments (Bail-in)	Transfer of Non-Performing Claims to BAMC	Tier 1 Capital Ratio after Transaction
NLB	1,551	1,140	411	257	711	15.0%
NKBM	870	619	251	64	422	16.8%
Abanka	591	348	243*	120	543*	9.0%†
Total	**3,012**	**2,107**	**905**	**441**	**1,676**	**–**

*Estimate.
†Tier 1 capital ratio after approval of provisional ruling for state aid (capital increase via cash in the amount of €348 million). The tier 1 capital ratio, the ratio of a bank's core equity capital to its risk-weighted assets, is a measure of a bank's capital adequacy.
Source: BOS, "Bank of Slovenia... ."

Table 4

Capital Deficits and Required Capital Injections for Slovenian Banks

Bank	Capital Deficit under the Adverse Scenario, €Million	Total Capital Increase, €Million
NLB	1,904	1,551
NKBM	1,055	870
Abanka	756	591
Slovenia's next five highest capital-deficient banks (Banka Celje, Gorenjska Banka, Hypo Alpe-Adria-Bank, Raiffeisen Banka, UniCredit Banka Slovenija)	1,064	Capital strengthening via money from private investors
Total	**4,778**	**3,012**

Source: BOS, "Bank of Slovenia... ."

The stress test results concluded that these three banks need an immediate combined capital injection of €3.012 billion financed from government cash and attractive, high-yield bond issuances in the form of sovereign securities (see Table 3 for specific figures). Shortly thereafter, NLB and NKBM submitted reorganization plans to the European Commission and received capital increases in mid-December 2013 after being deemed compliant with state aid rules. In mid-February 2014, Abanka sent its reorganization plan to the Ministry of Finance in Slovenia, which subsequently followed the same path through the European Commission as the other two banks' reorganization plans ("Abanka Restructuring Plan…"). Beyond receiving capital increases, NLB, NKBM, and Abanka will transfer a majority of their NPLs to the BAMC. In an effort to combat the high Slovenian government debt (government debt is expected to stand at 75.6 percent of GDP after executing banking sector restructuring plans) and ensure future banking sector health, the government plans to privatize many government interests, including total participating interest in NKBM and Abanka as well as most of its participating interest in NLB (BOS, "Bank of Slovenia…"). In addition to funding capital increases and the transfer of NPLs to the BAMC, the Slovenian government guarantees additional capital as a lender of last resort to banks facing troubling circumstances (BOS, "Report on Comprehensive…").

Strengthening Banking Sector Regulation

In understanding the Slovenian banking sector's past and present performance, regulation analysis is a paramount area to consider. In the wake of the global financial crisis, the ECB introduced a new European banking supervision department, tentatively named the Single Supervisory Mechanism (SSM), to improve transparency and management of European banks in an effort to encourage investor confidence and ensure banking stability within the EU. Under the SSM, all banking sector supervision will be harmonized under the same set of standard methodologies imposed by the ECB on all member states of the EU. The ECB will assume full EU banking supervision in November 2014 (BOS, "Report on Comprehensive…").

Beyond the roles of EU banking supervisory bodies, major responsibility for the appropriate management and supervision of the Slovenian banking sector regulation falls on banks' management boards, whereas regulations imposed on Slovenian banks on behalf of the BOS represent the minimum standards for banking operations (BOS, "Strategic Plan…"). Beyond the BOS regulations, European banks are guided by Basel III[9] regulations, which are all-inclusive sets of restructuring measures in banking practice regulation formulated by the Basel Committee on Banking Supervision (Bank for International Settlements). The objectives of these regulations are to strengthen the bank's transparency and disclosures, supervise, and improve risk management and governance of the banking sector. The Basel III regulations were formulated as a result of numerous weaknesses exposed by the recent financial crises in the global regulatory framework (Accenture). The regulations cover the following aspects: capital requirements, risk coverage, leverage, risk management, and supervision.

The Slovenian banking sector is subject to all Basel III's core principles. In order to gauge Slovenia's compliance, the International Monetary Fund conducted an assessment of Slovenia's banking sector's compliance with Basel III regulation in December 2012. The assessment concluded that the Slovenian banking sector is largely compliant with Basel III regulation (International Monetary Fund). In order to comply with the regulation, the BOS has transposed EU banking directives by harmonizing them with banking regulation in Slovenia. Although largely compliant, NLB, NKBM, and Abanka all failed to meet the BOS's capital requirements before stress tests were conducted. However, after the realization of capital increases and other restructuring measures across the Slovenian banking sector, banks' capital adequacy will increase, thereby revitalizing lending practices to creditworthy enterprises and allowing banks to address the remaining portion of NPLs that have not yet been transferred to the BAMC (BOS, "Bank of Slovenia…").

Independent Asset Quality Reviews

AQRs are complete reviews of individual loans and their corresponding rating classifications that identify loan impairments and allocate loan loss provisioning. The BOS contracted with experienced international consultants to conduct the 2013 AQRs and stress tests to ensure completeness and independence. As for the parties involved in the stress tests, the firms selected were Oliver Wyman (performing a bottom-up stress test analysis) and Roland Berger Strategy Consultants (performing a top-down stress test analysis). The firms selected to conduct the 2013 AQR were Deloitte and Ernst & Young (BOS, "Report on Comprehensive…").

Asset quality remains weak despite recapitalization and restructuring initiatives due to the large number of under-performing loans still on banks' balance sheets after the initial transfer of assets to the BAMC, high corporate leverage, and further credit deterioration ("Slovenian Banks' Bad…"). With the immense accumulation of deteriorating assets (e.g., NPLs) at the outset of Slovenia's financial crisis, it is vital that the government continue programs

[9] Basel III comprises a set of regulation standards that serve to strengthen global capital and liquidity rules aimed at creating a more resilient banking sector.

to conduct future independent AQRs to ensure long-term banking system health and strength. Measures to conduct AQRs are closely intertwined with the need to enforce stricter lending practices.

The Next Step: Enterprise Restructuring

The majority of NPLs on banks' balance sheets were lent to the corporate sector. Most Slovenian businesses have a highly levered[10] capital structure that inhibits Slovenian banks from revitalizing lending practices. In order to ensure a sound recovery, Slovenia must encourage corporate deleveraging and restructuring.

If firms are not restructured in the sense that their credit exposure is diminished, then banks will not be able to extend credit to the enterprise sector. Therefore, the BOS and the Slovenian government are developing an enterprise-restructuring strategy to normalize Slovenian firms' balance sheets and encourage firms to revamp borrowing practices. Before banks reinitiate lending practices, they have to be fully restructured; but in order to start lending, Slovenian banks must follow proper due diligence practices. If firms do not restructure, then the bleak outlook of the highly indebted enterprise sector will cause banks to be reluctant to lend. For banks, it is difficult to acquire new creditworthy clients because the firms that need credit generally carry more risk while the less risky creditworthy firms need less credit. In short, the enterprise sector must be restructured to encourage lending and stimulate the country's economic growth. In addition to enterprise financial restructuring, Slovenian enterprises must practice responsible ownership and ensure the implementation of sound business models in an effort to prevent future financial turmoil (BOS, "Stability of the Slovenian…").

Conclusion

With strong investor sentiment, strong consumer sentiment, and low interest rates, the situation in Slovenia was right for growth on borrowed money. In addition, the world financial crisis in late 2008 brought about a new era of uncertainty that revealed fiscal imbalances and severe shortcomings in the nation's banking system. Combined with a lack of due diligence and the dried-up pool of interbank market funds, the Slovenian banking system fueled the rapid decline of the country's economy. Despite severe problems plaguing the country's banking sector, it is evident that Slovenia will weather its devastating financial crisis without outside assistance, although growth will remain weak for the foreseeable future.

In conclusion, it is clear that the stability of the Slovenian banking system is a manageable situation. To ensure a sound economic recovery, Slovenia must continue the process of recapitalizing viable banks, transferring outstanding NPLs to the government-organized BAMC, ensuring strict compliance with BOS and EU banking regulations, and conducting regular AQRs to prevent further banking instability. Beyond these measures to restore Slovenia's banking sector, the government must work to continue privatizing struggling government-held firms, consolidating fiscal spending, and achieving corporate deleveraging and restructuring. With these initiatives underway, Slovenia will fully recover in the coming years and ensure stable, long-term economic prosperity.

[10]Leverage is a measure of a firm's capital structure. A highly levered firm finances the majority of its operations with debt rather than equity, which can generate higher returns but also increases risk and magnifies losses.

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