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Slovenian banks a decade later



Peter Zajc

1. Introduction

Yugoslavia's (1) economic system differed in many respects from the model pursued by other communist countries, and banking is certainly one of the areas where the country set itself apart from its peers. Yugoslavia had already introduced a two-tier banking system in the mid-1950s and also established a decentralised system of communal banks and savings institutions. In 1960, a new banking law further reduced the range of commercial activities of the National Bank of Yugoslavia (the central bank) and opened the way to the creation of commercial banks. To ensure that banks met the needs of non-financial enterprises, the latter were allowed to set up and own commercial banks (2). In the Yugoslav Republic of Slovenia, a milestone in the development of banking was the establishment of the Credit and Savings Bank Ljubljana in 1967, which accounted for about 70 percent of total banking sector assets in Slovenia (Prinčič, 2001) and later evolved into Ljubljanska banka (LB), Slovenia's largest bank. Towards the end of the 1960s, banking licenses were broadened, allowing banks to pursue international operations, including the establishment of representative offices abroad (3). Overall, banks became increasingly independent and profit-oriented (Štiblar, 1997).

In the 1970s, economic reforms - including those pertaining to banking - slowed down. What is more, connected lending, inevitably arising when non-financial enterprises own banks, intensified and, in addition, there was increasing political interference in lending decisions. As a result, many loans were *de facto* donations, banks developed an excessive exposure to single clients, and bad loans accumulated. In addition, a dramatic currency mismatch on banks' balance sheets emerged. This was because the government encouraged banks to take foreign currency deposits to alleviate Yugoslavia's foreign currency shortages but at the same time restricted their foreign currency lending. When inflation accelerated, the domestic currency started to depreciate rapidly, causing large bank losses. With mounting bad debts and foreign currency losses, banks could only survive with repeated government bail-outs. Nevertheless, in 1990, on the brink of Yugoslavia's disintegration, up to 40 percent of banking sector assets in Slovenia were non-performing (Savin, 2000).

Overall, while sharing the bad debt problem with other Central and Eastern European countries (CEECs), Yugoslavia's banking system was more advanced than other CEEC banking systems and, thus, Slovenia started from a more favourable position when embarking on the transformation of its banking sector after gaining independence in 1991. Against this background, this paper analyses where the Slovenian banking sector stands a decade into the transition to a market economy. The

Peter Zajc is a Research Fellow with the Faculty of Economics at the University of Ljubljana and visited the EIB during this research. Thanks are due to Armin Riess and Rien Wagenvoort for insightful comments. The views expressed are strictly personal.

1) The term Yugoslavia refers to the former Yugoslavia, established after the Second World War and started to disintegrate in late 1980s.

2) A distinguishing feature of Yugoslavia's economic system was "social" rather than state ownership. Social ownership implied that no legal entity or private person had a claim on equity (Ribnikar, 1992).

3) Ljubljanska banka, in particular, had a strong presence abroad, with 22 representative offices around the world (Štiblar, 1997).

rest of the paper is organised in three main sections. The next section reviews the rehabilitation of the Slovenian banking sector and examines its structure, size, and its assets and liabilities. Section 3 looks at the profitability and soundness of banks. Finally, Section 4 turns to two issues that continue to be debated in Slovenia, namely privatisation and the role of foreign direct investors.

2. Key features of the Slovenian banking sector

2.1 Bank rehabilitation

Slovenia's banking sector was in a difficult situation at the beginning of the 1990s. In addition to the inherited bad debt problem, many customers defaulted on their loans as a result of the transition recession in 1990-92. Moreover, the National Bank of Yugoslavia seized most of the foreign currency assets of Slovenian banks (85 percent of foreign currency assets had to be kept with the National Bank of Yugoslavia in Belgrade). And then, banks lost claims on borrowers in other Yugoslav republics while they still had to honour liabilities such as "joint" Yugoslav liabilities to foreign creditors.

To address the bad debt problem, the Bank Rehabilitation Agency (BRA) was established in October 1991. Its purpose was to design and administer the bank rehabilitation programme, which started in early 1993. A bank was put under rehabilitation if non-performing assets exceeded 50 percent of its capital. This was the case with the two largest banks (LB and Kreditna banka Maribor or KBM), accounting for more than 50 percent of total banking sector assets. Two new legal entities were created (Nova Ljubljanska banka or NLB and Nova Kreditna banka Maribor or NKBM) to disconnect all links with branches and subsidiaries in other Yugoslav republics (4).

In rehabilitating the banking system, the state assumed ownership of the largest banks and removed a good part of the bad debt from their balance sheets.

The bank rehabilitation strategy comprised three main elements:

- Two-thirds of the value of NLB's and NKBM's bad loan portfolio were transferred to the BRA and replaced with government bonds (about EUR 900 million, equivalent to 10 percent of GDP in 1993). The remainder stayed on the balance sheets of NLB and NKBM to induce them to restructure and possibly recover non-performing loans. The policy of forcing banks to actively contribute to the resolution of the bad debt problem gave them useful experience in the workout of bad loans (Moore and Zajc, 1999).
- The ownership of NLB and NKBM was transferred from non-financial enterprises to the state. In contrast to other CEECs where bank restructuring was a precursor to the privatisation of state-owned banks, the Slovenian state became an owner of the largest banks only in the context of the bank rehabilitation programme (5).
- The management of NLB and NKBM was replaced. The motivation for this was not only to put the banks in the hands of adequately skilled staff but also to ensure arm's-length lending instead of connected lending.

4) In January 1994, Kreditna banka Nova Gorica was the third bank to participate in the rehabilitation programme. In 1995, this bank merged with NKMB. The need for rehabilitating other banks was less pronounced. While they also received some government support, the rehabilitation programme did not cover them.

5) As for the other banks owned by non-financial enterprises, there was only an indirect change of ownership when the status of these "socially-owned" non-financial enterprises was clarified. See Ribnikar (1998) and Moore and Zajc (1999) for a discussion of social ownership, "ownershipisation", and privatisation in Slovenia.

Bank restructuring and recapitalisation has resulted in a well-capitalised banking sector.

As to banks' liabilities, it is worth pointing out that Slovenia adopted a territorial principle in dealing with deposits. This meant that following the break-up of the Yugoslav monetary system, clients could withdraw deposits only if they were with banks - Slovenian or non-Slovenian - on Slovenian territory. At the same time, deposits with Slovenian banks in other Yugoslav republics could not be withdrawn. This contributed, on the one hand, to establishing confidence in the Slovenian banking sector. On the other hand, the default of Slovenian banks - essentially LB - on deposits taken in other Yugoslav republics became a major obstacle to the expansion of Slovenian banks into other Yugoslav republics, notably Croatia; in addition, there have been attempts to sue NLB, i.e. the successor of LB (6).

Overall, the bank rehabilitation process, which ended in June 1998, was successful. NLB and NKBM, which were essentially insolvent at the beginning of the process, reached capital adequacy ratios of over 10 percent in 1997. Bad loans have been partly recovered and partly written off, and new loans are extended following modern risk appraisal methods.

2.2 Ownership structure and concentration

In 2000, the banking sector that had emerged after the completion of the rehabilitation process differed markedly from the banking sector in most other CEECs. For one thing, with a share of 42 percent of banking sector assets in 2000, state-owned banks (i.e. banks in which the state holds at least 50 percent of the equity) dominated the market (see Table 1). In fact, the number of state-owned banks and their market share did not change very much in the second half of the 1990s. In addition to NLB and NKBM - with a 40 percent market share - the government owned the Postal bank (7). Taking into account indirect state ownership, such as NLB stakes in other banks, the total market share potentially controlled by the state is much larger. For another, foreign banks (i.e. banks in which non-residents hold at least 50 percent of the equity) played only a marginal role, accounting for less than 6 percent of banking sector assets.

Table 1. Number of banks and market shares

	1996	1997	1998	1999	2000
Number of banks	31	28	24	25	25
of which: state-owned	3	3	3	3	3
foreign-owned	4	4	3	5	5
Market share (in % of assets)					
State-owned banks	40.1	40.2	41.3	41.8	41.6
Foreign-owned banks	5.3	5.4	4.9	4.8	5.5
3 largest banks	51.7	50.8	51.7	51.4	50.2
5 largest banks	62.6	62.2	63.3	63.5	62.5

Source: Bank of Slovenia.

6) The Republic of Slovenia claims that pre-independence deposits are subject to intergovernmental negotiations of successor states. However, private lawsuits against NLB have been or are being filed by depositors from Croatia, Bosnia and Herzegovina, and Macedonia.

7) In 2001, state ownership of banks slightly increased as the City of Ljubljana through its public utility companies acquired a majority share in Slovenska investicijska banka (SIB).

State ownership and a limited role of foreign investors continue to be a salient feature of Slovenia's banking system ...

Table 1 also shows that concentration in the Slovenian banking sector is fairly high. The three largest banks (NLB, NKBM and SKB) account for half of the market and the five largest for almost 63 percent. To put things into perspective, many EU banking sectors have similar, if not higher, concentration ratios (Belaisch *et al.*, 2001). Concentration in the Slovenian banking sector increased at the end of 2001 when three NLB group member banks merged with NLB. Moreover, the concentration is even higher if assets of other NLB group member banks, in which NLB holds a minority equity stake, are considered. In the future, an increase in market concentration is likely to further consolidation among Slovenian banks.

2.3 Financial depth and the size of the banking sector

Has the large presence of state-owned banks and the virtual absence of foreign-owned banks hampered the development of banking in Slovenia? Figure 1, which shows three commonly used indicators to investigate the financial depth of the Slovenian economy and the importance of banking, suggests that this has not been the case. One indicator is the ratio of broad money to GDP (8). As Figure 1 shows, this ratio increased from about 30 percent in 1993 to 50 percent in 2000. While this certainly suggests an increasing role of money in the economy, the ratio remains well below the average EU level of 80 percent.

An indicator that focuses directly on the intermediation of funds through the banking system is the ratio of domestic bank claims to GDP (9). In 1993-2000, this ratio increased by 20 percentage points, reaching almost 50 percent. There is thus clear evidence that the role of banks in the economy has become more important, though it remains below the degree of bank intermediation observed in the EU. But it is of more relevance to note that bank claims to GDP are not only higher but have also grown far more rapidly in Slovenia than on average in the CEECs.

The previous indicator does not distinguish between different groups of borrowers. There seems to be little doubt that the provision of funds to the private sector is of particular importance for economic growth and development. With this in mind, the third indicator in Figure 1 pictures the share of bank claims on the domestic private sector. We find again an encouraging trend, with bank claims on the private sector increasing from 19 percent of GDP in 1993 to 35 percent in 2000. Again, on this count, Slovenia has outperformed many CEECs.

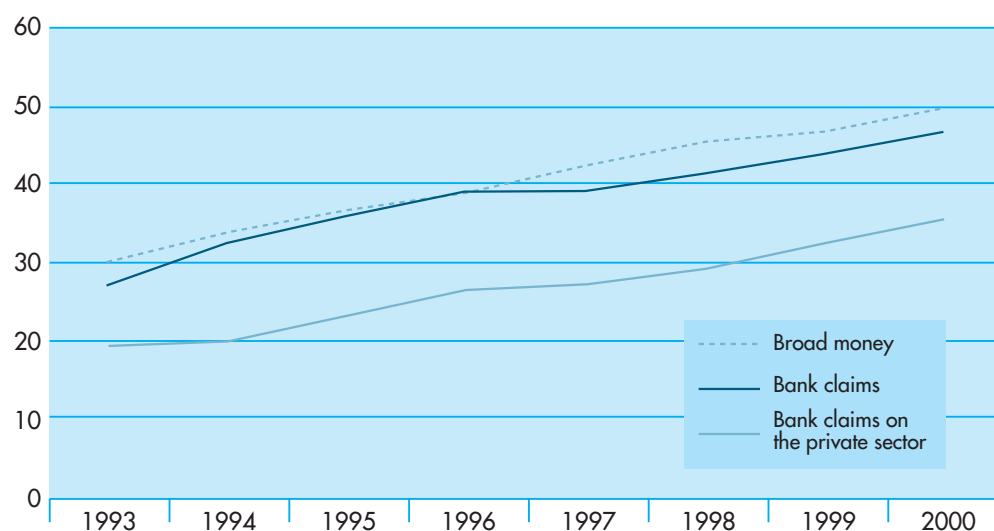
In sum, during the first decade of transition, Slovenia's banking sector has grown rapidly though from a low base. Relative to EU countries, Slovenia is still lagging behind but this is not at all surprising as the process of catching up with more advanced economies was bound to take time. It is worth emphasising that banking in Slovenia has developed more rapidly than in many other CEECs.

8) Broad money is defined as the sum of money and quasi money. Broad money is often used as proxy for M2. See Beck *et al.*, (1999) for a discussion on financial development indicators.

9) An alternative measure for the size of a country's banking sector is the ratio of bank assets to GDP. The coverage of bank assets is broader than that of domestic bank claims. Bank assets also include claims on foreigners and fixed assets as well as the assets of banks that the IFS database of the IMF do not cover. The bank asset-to-GDP ratio confirms the speedy development of banking activities in Slovenia. The ratio increased from about 65 percent in 1995 to almost 80 percent in 2000.

... but this does not seem to have been an obstacle to increased bank intermediation.

Figure 1. Indicators of financial depth and banking sector size, in % of GDP



Sources: International Monetary Fund, IFS.

2.4 The structure of banks' balance sheets

We have seen that Slovenia's banking sector has grown relative to the size of the economy. But have some sectors of the economy participated more in this development than others? To shed some light on this question we investigate the structure of bank assets and liabilities.

The most visible change on the assets side of banks' balance sheets is the steep decline in the share of foreign assets in total assets, reaching 14 percent in 2000 (Table 2). This has been mainly due to an increasing confidence in the domestic currency (the Tolar) and a change in prudential regulations that allowed banks to hold up to 60 percent of their statutory foreign exchange reserve in foreign currency denominated securities issued by the Bank of Slovenia.

As for domestic assets, there has been a rapid rise in the share of claims on households, reflecting a debt-financed consumption spree after years of suppressed consumption (10). By contrast, claims on domestic enterprises have become only slightly more important in the portfolios of banks, accounting for about 31 percent of total assets in 2000. While some claims on enterprises do not reflect the intermediation of funds (e.g. bonds and equity acquired in secondary trading rather than through initial and secondary public offerings), the bulk of such claims are indeed the result of intermediating funds between savers and enterprises (11). What is more, almost all of the bank claims on enterprises are loans. Obviously, loans to enterprises must not be confused with lending to the private sector as they include lending to state-owned enterprises, which are still numerous in Slovenia - not only in traditional public sectors such as telecommunications, energy and transport.

10) There has been, for example, a strong increase in loan-financed car purchases.

11) In any case, 90 percent of the domestic, non-financial sector securities held by banks are government securities.

Table 2. Structure of banking sector assets, in %

	1996	1997	1998	1999	2000
Domestic assets	<u>79.6</u>	<u>84.9</u>	<u>86.6</u>	<u>87.2</u>	<u>86.0</u>
Claims on financial sector	15.4	21.8	19.5	17.1	17.1
Claims on central bank	11.6	19.5	17.4	14.7	13.9
Claims on domestic banks	3.8	2.3	2.1	2.4	3.2
Claims on non-financial sector	58.1	57.1	60.8	63.4	62.3
Claims on enterprises	28.3	27.2	30.5	30.7	30.9
Claims on households	11.5	11.5	12.6	15.9	15.1
Claims on government	17.8	17.8	16.9	15.5	14.7
Claims on other organisations	0.5	0.6	0.8	1.4	1.6
Other domestic assets	6.1	6.0	6.3	6.6	6.6
Foreign assets	<u>20.4</u>	<u>15.1</u>	<u>13.4</u>	<u>12.8</u>	<u>14.0</u>

Source: Bank of Slovenia.

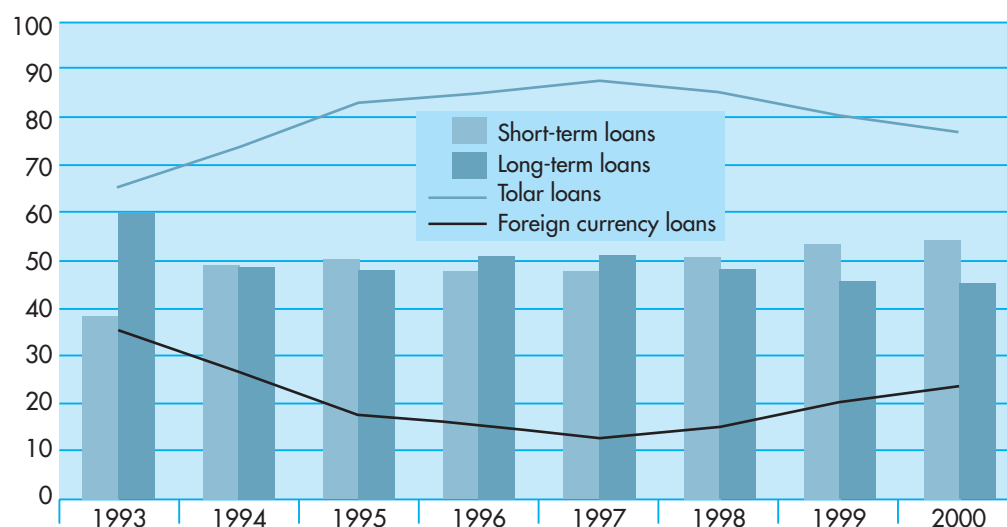
Reflecting the country's success in catching-up with more advanced economies, bank lending to enterprises and households has grown faster than economic activity.

Although modest, the increase in loans to enterprises in percent of assets at a time when bank assets have been growing faster than the Slovenian economy implies that lending to the enterprise sector has grown more rapidly than economic activity itself. This was not necessarily to be expected, given a number of factors that tended to curtail the demand for or the supply of loans. First, having emerged from a bad debt problem, it would not have been completely surprising if banks had taken an excessively cautious approach towards new lending. Second, because of solid economic growth at home and in major export markets, Slovenian enterprises performed well in the second half of the 1990s and, thus, internally generated funds contributed considerably to the financing of investment. Finally, although still modest, foreign direct investment and other international capital flows have increasingly become alternative sources of finance, for large companies with international operations in particular.

Before moving on to the liability side of the banks' balance sheets we take a look at the term and currency structure of assets. Figure 2 indicates that the share of short-term loans to domestic enterprises in total loans to enterprises increased from 38 percent in 1993 to almost 50 percent a year later and continued to rise thereafter, reaching 54 percent in 2000. On average, the maturity of bank loans to enterprises therefore shortened. Figure 2 also indicates that in recent years the currency composition of loans to enterprises changed in favour of foreign currencies. The share of foreign currency denominated loans started to increase in 1997, reaching 25 percent of the total in 2000. This has demand-side as well as supply-side explanations. The demand for foreign currency loans went up in response to an increasing export orientation of the Slovenian economy (the country's export-to-GDP ratio is around 50 percent). In essence, foreign currency loans better match exporters' (foreign currency) revenue than domestic currency loans (12). On the supply side, banks could safely increase the supply of foreign currency loans to domestic enterprises because they were successful in mobilising more foreign currency denominated funds.

12) Table 2 demonstrates that the increase in the share of foreign currency denominated loans went together with a decline in the share of foreign assets in total assets. This confirms that Slovenian borrowers accounted for the increase in foreign currency loans.

Figure 2. Maturity and currency structure of loans to domestic enterprises, in % of total



Source: Bank of Slovenia.

The importance of deposits, in particular from households, has increased with growing confidence in the country's banking sector.

Turning to the structure of bank liabilities, we note first that the breakdown into domestic and foreign liabilities has changed little since the mid-1990s: The share of domestic liabilities in total liabilities averaged about 90 percent (Table 3); foreign liabilities are equivalent to some 10 percent of the balance sheet and continue to fall short of foreign assets (Table 2); the Slovenian banking system has thus maintained its net external creditor position with the rest of the world.

What is more striking, however, is the change in the composition of domestic liabilities, most of which occurred in the first half of the 1990s. As Table 3 shows, the share of financial sector liabilities dropped from 12 percent of the total to below 4 percent in 2000. About 80 percent of financial sector liabilities are interbank liabilities and the remainder reflects banks' borrowing from the central bank. The decline in financial sector liabilities went together with an increase in liabilities to the non-financial sector of the Slovenian economy, which increased from about 50 to 65 percent of total liabilities. Securities issued by banks represented a very small source of funding (3 percent of total liabilities).

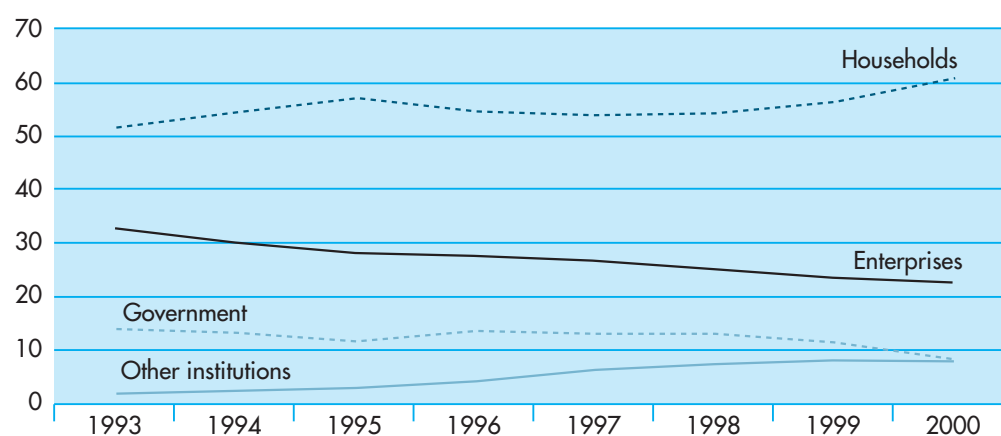
Table 3. Structure of banking sector liabilities, in %

	1993	1994	1995	1996	1997	1998	1999	2000
Domestic liabilities	85.0	87.3	88.0	88.6	90.2	91.1	89.8	88.5
Financial sector	12.0	8.9	7.1	4.9	3.1	2.3	3.2	3.7
Non-financial sector	51.3	54.7	56.3	62.1	65.7	68.0	66.3	64.6
Equity and reserves	15.2	17.5	16.9	15.9	15.3	14.7	14.2	13.5
Securities issued	2.0	1.7	2.9	2.1	2.5	2.4	2.2	2.6
Other liabilities	4.5	4.5	4.8	3.6	3.6	3.7	3.9	4.1
Foreign liabilities	15.0	12.7	12.0	11.4	9.8	8.9	10.2	11.5

Source: Bank of Slovenia.

Figure 3 provides details on the composition of non-financial sector liabilities. The share of household deposits increased by ten percentage points, reflecting growing confidence of the population in Slovenia's banking sector after years of uncertainty arising from the bad experience of depositors with the domestic (Yugoslav) financial system. Deposits with the banking sector remain the most important saving instruments for households given that the Slovenian capital market is small and illiquid and that investment funds are still in their infancy. Mirroring the increase in liabilities to households, the share of enterprises in banks' non-financial sector liabilities declined steadily and reached 23 percent 2000. In essence, enterprises have been under pressure to use their funds productively or return them to owners, but not to keep excessive bank deposits.

Figure 3. Breakdown of domestic non-financial sector liabilities, in % of total

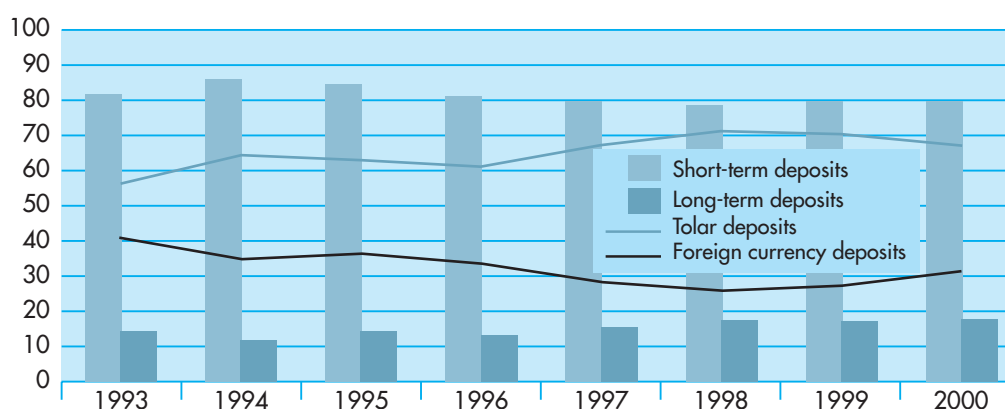


Source: Bank of Slovenia and own calculations.

The term structure of bank assets and liabilities has shortened and long-term funds continue to be scarce.

The term structure of liabilities to the domestic non-financial sector shows a slightly increasing share of long-term deposits, which accounted for around 17 percent of total liabilities in 2000 (Figure 4). Although this trend is promising, it is not very strong and the shortage of long-term sources of funds remains a characteristic of the Slovenian banking sector. The share of foreign currency deposits in total liabilities fell in the period through 1998, but has increased again since then, reaching around 30 percent in 2000.

Figure 4. Maturity and currency structure of non-financial sector liabilities, in % of total



Sources: Bank of Slovenia and own calculations.

2.5 Distribution channels and banking products

In terms of banking sector products and the channels used for offering them to customers, Slovenia is closer to the EU benchmark than most other CEECs (13). Each bank in Slovenia serves on average 80 000 inhabitants, which is also the average for the euro area (14). More informative than this indicator is the number of inhabitants per bank branch. In Slovenia, one branch serves around 3 500 inhabitants, which compares to a euro area average of 2 000 (15). There are also similarities in the number of employees per bank branch, which is 19 in Slovenian and 15 in the euro area.

The depth and type of distribution channels of the Slovenian banking sector are relatively advanced.

Like elsewhere in the world, branch networks are becoming less important in Slovenia as new distribution channels increasingly replace the need for physical contact with a bank employee. For instance, the availability of automatic teller machines (ATMs) more than doubled from 1996 to 2000. As a result, one ATM currently serves about 2 300 inhabitants, which is close to the euro area average of about 1 900. In addition, the range of services offered through ATMs increased as well. Phone and internet banking (introduced in 1997) has been on the rise as well.

As to banking sector products, bank accounts have been around in Slovenia for several decades and people use them extensively (16). In 2000, almost 80 percent of the population older than 15 years had a bank account and almost three quarters of them use bank cards. Furthermore, the use of credit and debit cards has become very popular: By mid-2001, 770 000 credit cards and 1 440 000 debit cards had been issued, which was for a population of two million.

In sum, the Slovenian banking sector seems fairly advanced in providing low-cost distribution channels for key banking services.

2.6 A brief summary

Slovenia's bank rehabilitation programme has been successful in creating confidence in the banking sector. Privatisation and foreign direct investment have been late and, as a result, private ownership of banks and the degree of foreign involvement are considerably lower than elsewhere in the region. Interestingly enough, this does not seem to have been an obstacle to an increase in financial depth and bank intermediation. The growth in bank intermediated funds has spread across all sectors of the economy, but non-financial enterprises and, in particular, households have benefited most. While lending to and borrowing from non-residents has become less significant, the Slovenian banking sector has maintained its net external creditor position with the rest of the world. Finally, the range of bank services and distribution channels is beginning to resemble that of a modern banking system.

The progress made in creating a functioning banking sector has supported Slovenia's economic development. But it is clear that this process is sustainable only if banks are profitable in mobilising and allocating financial savings and in providing other banking services. We address this issue next.

13) We focus here on a comparison of Slovenia with the EU. For data on selected CEECs see, for instance, Hampel (this volume) and Riess et al., (this volume).

14) Euro area data are for 1998 and exclude Luxembourg (see Belaisch et al., 2001).

15) When comparing these numbers, one has to bear in mind different geographic and demographic characteristics of the countries. For example, a high concentration of the population in urban areas reduces the number of bank branches but increases the number of employees per branch.

16) Although prohibited by law, many Slovenians, due to a relatively liberal regime in the former Yugoslavia, also opened and kept bank accounts abroad, mostly in the neighbouring provinces in Austria and Italy.

3. Profitability and soundness of Slovenian banks

3.1 Profitability

To arrive at an answer to the question of whether banks have been profitable, we note first that, despite some decline in recent years, the income from intermediating funds (i.e. banks' net interest income) continues to be far more important for Slovenian banks than for EU banks. Table 4 shows that interest income accounts for about 73 percent of gross income in Slovenia, compared to a EU average of 58 percent (17). Obviously, the importance of interest income in Slovenia mirrors the still relatively limited scope for providing other banking services, notably investment banking and asset management services. But it is also explained by a comparatively high interest margin (i.e. the ratio of net interest income to average earning assets). Figure 5 indicates that the interest margin of Slovenian banks has been, on average, close to 5 percent since the mid-1990s. This is substantially above the EU average of 1.5 percent.

Net interest margins are high, reflecting still relatively large provisions and write-offs as well as a lack of competition.

A variety of factors determine interest margins, but the level of operating costs, the need to provide for non-performing loans, and the degree of competition seem to be most critical. Table 4 indicates that the cost-to-income ratio (i.e. operating cost in percent of gross income) of Slovenian banks is around 60 percent, which is essentially the same as in the EU. Turning to provisions for non-performing loans and write-offs, Table 4 shows that this item in the income statements of Slovenian banks has remained high, accounting for 22 percent of gross income in 2000, which is almost double the EU average. Evidently, high provisions suggest that Slovenian banks still have to cope with a substantial bad loan problem, an issue to which we will return below. Finally, it has been observed that Slovenia's banking sector is not very competitive, reflecting - in part - the high degree of concentration (IMF, 2000b). Overall, it seems fair to conclude that a lack of competition and large provisions explain a good part of the high interest margins in the Slovenian banking sector.

Table 4. Average income statement of Slovenian and EU banks, in % of gross income

	1997	1998	1999	2000	EU 1998
Gross income	100.0	100.0	100.0	100.0	100.0
Net interest income	75.3	74.0	70.8	72.6	57.5
Net non-interest income	24.7	26.0	29.2	27.4	42.5
Operating costs	61.4	63.3	65.2	58.9	61.2
Labour costs	31.5	31.5	32.6	28.9	33.7
Other operating costs	29.9	31.8	32.6	30.0	27.5
Net income	38.6	36.7	34.8	41.1	38.8
Provisions and write-offs	19.8	15.4	19.7	21.9	11.7
Profit before tax	18.8	21.3	15.0	19.2	27.1
Tax	5.1	8.1	7.5	7.4	9.0
Profit after tax	13.7	13.2	7.5	11.7	18.0

Notes: Net interest income is the difference between interest income and interest expenses. Likewise, net non-interest income is the difference between commissions/fees received and paid. Gross income is the sum of the two. Sometimes gross income is labeled operating income.

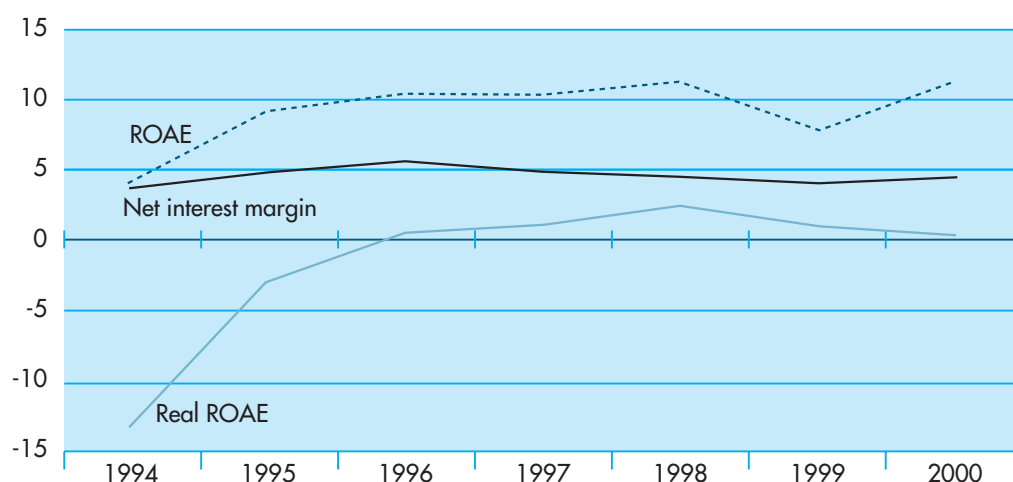
Sources: Bank of Slovenia, OECD (2001).

17) In the EU, the share of interest income ranges from 41 percent in France to 68 percent in Spain.

Moving on to profits, Table 4 suggests that interest margins have been sufficiently high to generate profits despite considerable provisions and write-offs. Indeed, Figure 5 demonstrates that Slovenian banks have generated positive nominal returns on equity since 1994. The nominal return on average equity (ROAE) has been close to, and in some years even above, the EU average. Have Slovenian banks therefore generated adequate returns to shareholders? Apparently not! Inflation in Slovenia has been much higher than in the EU and the comparison of nominal returns is thus misleading. To take this into account, Figure 5 also shows inflation-adjusted returns on equity for the Slovenian banking sector. The results are fairly disappointing: While real returns have been positive since 1996, they have remained below 2.5 percent, which is some six percentage points below the EU average.

Figure 5. Key performance indicators of the Slovenian banking sector, in %

Banks' profitability appears acceptable in nominal terms, but real returns on equity are disappointing.



Sources: Bank of Slovenia and own calculations.

It is worth pointing out that the profitability of Slovenian banks has been low, despite a number of peculiar institutional features that have worked in favour of banks. To begin with, in 1995, the Bank of Slovenia endorsed an agreement among banks to cap interest deposit rates while leaving banks free to set lending rates (IMF, 2001). The background to this was an aggressive attempt, of small banks in particular, to expand their lending base by offering high deposit interest rates. In these circumstances, the cap on deposit rates was considered an instrument to contain systemic risks and to avoid excessive borrowing costs. Although the agreement was officially abolished in early 1999, *de facto* it remained effective until late 2000. In addition, in contrast to other investment income, interest revenues from bank deposits are not taxable. This tends to reduce banks' funding costs without necessarily triggering downward pressure on lending rates.

Second, banks benefit from an asymmetric inflation indexation of assets and liabilities. Inflation indexation of financial contracts was introduced in the early 1990s to restore confidence in the domestic currency following a period of hyperinflation. Interest rates are set in real terms and a revaluation clause ensures that nominal rates are adjusted to compensate for past inflation (IMF, 2000b). However, indexation of bank assets is more comprehensive than that of bank liabilities. For instance, demand deposits are not indexed and are remunerated at 1 percent nominal interest rate. Evidently, banks benefit from an inflationary environment. Indeed, estimates suggest that the

The performance of banks has benefited from a number of peculiar institutional features that are now being removed.

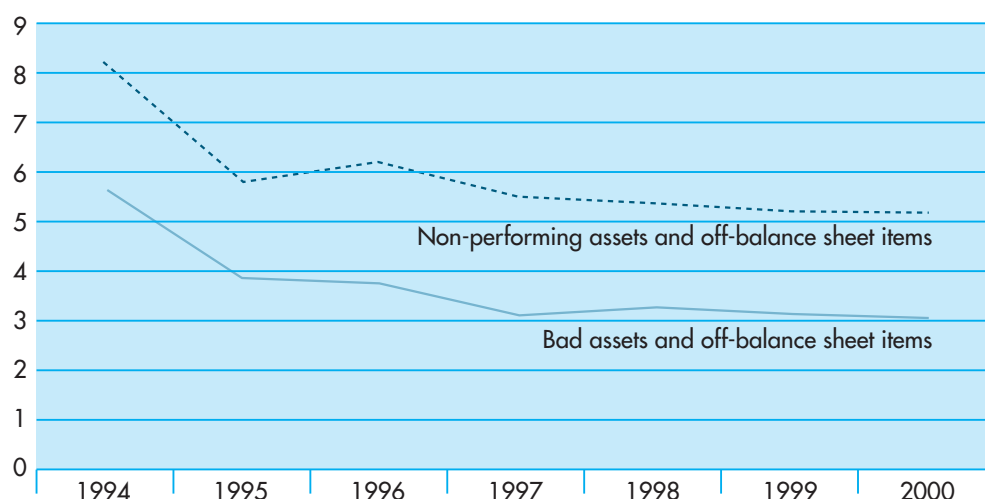
interest income arising from asymmetrically adjusting financial contracts for inflation has been equivalent to about 40 percent of total net interest income. What is more, a Bank of Slovenia study (18) seems to suggest that without the interest revaluation gain only five of the 25 banks covered in Table 4 would have reported positive profits in the second half of the 1990s (19).

Finally, banks have benefited from the ready availability of high-return, low-risk Bank of Slovenia securities, which reflect the central bank's attempt to sterilise the injection of liquidity resulting from its foreign exchange market intervention that have aimed at containing the real appreciation of Slovenia's currency.

3.2 Soundness

We conclude this section with a brief assessment of the soundness of the Slovenian banking sector. A sign of improving soundness is that the share of non-performing assets and off-balance sheet items in total on- and off-balance sheet items declined from 8 percent in 1994 to 5 percent in 2000 (Figure 6). During the same period, bad assets and off-balance sheet items - a subcategory of non-performing assets and items - declined to around 3 percent.

Figure 6. Non-performing assets and off-balance sheet items, in %



Note: Non-performing assets are subdivided in "substandard", "doubtful" and "loss". Only the latter two categories are included in bad assets.

Source: Bank of Slovenia.

Another encouraging sign is that Slovenian banks are well capitalised. Although the average capital adequacy ratio (i.e. banks' capital in percent of risk-weighted assets) has fallen from almost 22 percent in 1995 to about 14 percent in 2000, it still remains well above the Basel guideline of

18) This study has not been published but reported about in Slovenia's financial press. See, for instance, *Gospodarski vestnik* (2001).

19) A big-bang abolition of indexation is not planned. Instead, a gradual phase-out is envisaged so that banks have time to refocus their operations. The plan is to gradually lengthen the maturity of non-indexed financial contracts. The first step was taken in 2001 when the indexation of financial contracts with a maturity of up to 30 days was abolished. The indexation of other short-term financial contracts is to be abolished by end of June 2002.

8 percent and the EU average. In fact, some reduction in the capital adequacy ratio from the high 1995 level was to be expected as banks tried to achieve higher returns on equity and given that less capital became necessary on the back of declining non-performing assets.

While standard prudential indicators suggest that Slovenia's banking sector is relatively sound, its long-term viability requires a boost in profitability.

In sum, while the soundness of Slovenia's banking sector has improved, banks' profitability is not what it appears to be at first sight. Real returns on equity are low and have to rise in order to sustain the long-term expansion of the sector. So, the challenge is clearly to improve the efficiency and profitability of banking, and one wonders whether further privatisation and a larger engagement of foreign investors can be helpful in this respect. This takes us to a question Slovenia has been struggling with for quite some time.

4. What to make of privatisation and foreign investors?

Empirical evidence suggests that state ownership in banking slows down financial sector development and economic growth (see, for instance, World Bank, 2002). There is also evidence that the entry of foreign banks raises the efficiency and stability of banking in emerging markets, thus contributing to economic growth (IMF, 2000a). Obviously, foreign ownership in the banking sector may have costs such as potential systemic instability and problems in supervising multinational banks (Clarke *et al.*, 2001). But these issues seem to be less relevant for the Accession countries of Central and Eastern Europe given their increasing economic and political integration with the foreign investors' home countries. Against this background, multilateral development institutions and the EU advised Accession countries to privatise state-owned banks and to engage foreign strategic investors in this process.

Most CEECs followed this advice - some did so sooner than others. By contrast, Slovenia pursued an inward-looking, gradual strategy in rehabilitating its banking sector. The sector has been kept relatively closed and protected from foreign competition. It would be difficult to argue, however, that Slovenia has been less successful than more radical CEEC reformers in creating a functioning banking sector. On the contrary, we have seen that bank intermediation developed quite rapidly and no major banking crises occurred (20). It is true that the sector lacks profitability, but as Riess *et al.*, (this volume) argue, this is a feature that Slovenia shares with other CEECs.

While Slovenia has been sceptical about both privatisation and strategic foreign investors, things have started to change recently. To begin with, in 2001, Société Générale of France acquired SKB, the third largest bank in Slovenia (21). And then, this year SanPaolo IMI of Italy bought Banka Koper. Moreover, Raiffeisen Zentralbank of Austria is planning to take over Krekova banka. All these acquisitions involve private Slovenian banks and thus do not reduce the role of state-owned banks. In this respect, changes are on the horizon with the planned sale of NKBM, the second largest state-owned bank, to foreign strategic investors. Overall, the transactions mentioned here would increase the market share of foreign-owned banks to around 35 percent, up from 6 percent in 2000; at the same time; the share of state-owned banks would fall from over 40 percent to 30 percent.

20) Two smaller banks were closed down, *Komercialna banka Triglav* in 1996 and *Hipotekarna banka Brežice* in 1998. This did not cause instability in the banking sector.

21) See Table A.1 in the Annex for a list of all Slovenian banks.

As mentioned above, the sale of NKBM to foreign strategic investors is planned rather than realised. Public opinion in Slovenia continues to be in favour of selling NKBM and, eventually NLB, to domestic investors, arguing that this would better serve the national interest. We find national interest difficult to define, but it is clear that Slovenia must have a keen interest in an efficient, sound, and shock resistant banking sector. Arguably, a very high proportion of foreign bank ownership is not a panacea but we have little doubt that an increased presence of foreign banks is beneficial for the Slovenian economy. In any case, Slovenian financial institutions and pension funds do not have the strength to acquire the country's large state-owned banks and this leaves privatisation to foreign investors as the only realistic option for some time to come. Whether the sale of NKBM will be completed this year is still uncertain although privatisation proceeds have already been accounted for in the 2002 government budget.

A number of private Slovenian banks have been sold recently to foreign banks, but the degree of involving foreign investors in the privatisation of large state-owned banks continues to be debated.

A 35 percent market share of foreign-owned banks and increasing competition from cross-border lending should be sufficient to produce the hoped for benefits of foreign bank ownership. Domestically-owned banks will have to become more efficient to remain in business, but there is little reason why they should not be successful in coping with this challenge. After all, Slovenian banks are stronger than banks in other CEECs had been when they were exposed to foreign competition. In the end, the foreign-domestic ownership structure emerging in Slovenia may turn out to be more balanced than elsewhere in the region.

The future will bring new challenges for Slovenia's banks, no matter who owns them. The institutional setting, which may have been helpful in protecting an infant banking industry, is being revamped. With the phasing out of the asymmetric inflation indexation of financial contracts a substantial source of bank revenues will disappear and banks will have to find other sources of revenue, better exploit existing ones, and reduce costs. These are no minor tasks for Slovenia's banking sector in the second decade of the country's independence.

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Annex

Table A1. Slovenian banks and their market share by bank assets, in %

Rank	Bank	1999	2000	2001
1	Nova Ljubljanska banka (NLB)	28.0	28.8	28.3
2	Nova Kreditna banka Maribor (NKBM)	12.0	11.5	11.7
3	SKB	11.4	10.1	9.6
4	Banka Koper	6.2	6.2	6.4
5	Abanka	5.6	5.9	6.2
6	Banka Celje	5.8	5.8	5.9
7	Gorenjska banka	4.8	5.0	5.0
8	Dolenjska banka*	3.3	3.2	3.1
9	Bank Austria Creditanstalt	3.1	3.0	3.1
10	Pomurska banka*	2.3	2.3	2.3
11	Krekova banka	2.2	2.1	2.0
12	Banka VIPA	2.0	1.9	1.8
13	Poštna banka Slovenije	1.8	1.8	1.8
14	Probanka	1.5	1.5	1.5
15	Banka Domžale*	1.4	1.4	1.5
16	Koroška banka*	1.4	1.5	1.4
17	SZKB	1.5	1.5	1.4
18	Banka Velenje*	1.4	1.3	1.3
19	Volksbank - Ljudska banka	0.9	1.0	1.0
20	SIB	0.9	0.9	1.0
21	Banka Zasavje*	1.0	0.9	0.9
22	Factor banka	0.7	0.8	0.9
23	Hypo Alpe-Adria-Bank	0.4	0.7	0.8
24	Banka Soci�t� G�n�rale	0.4	0.4	0.5
25	K�rntner Sparkasse	0.0	0.0	0.5

Notes: For 2001, data as of end-June. * indicates members of the NLB group.

Source: Bank of Slovenia.