Impact of the economic crisis on the credit market in Slovenia

SUMMARY

The situation in Slovenia's financial sector tightened further in 2011. The volume of Slovenian bank loans to non-banking sectors recorded the largest decline thus far, as a result of both a very limited supply of and a lower demand for loans, which are the main source of finance for Slovenian enterprises. All these factors also represent a risk to Slovenia's lending activity in the future. We estimate that the situation in Slovenia's financial system was one of the important reasons why economic activity in Slovenia again recorded an above-average slowdown.[1]

External factors remain a significant obstacle to the lending activity in Slovenia. The situation on interbank markets tightened significantly in late 2011 due to a lack of confidence between banks in view of the deepening of the sovereign debt crisis. The supply of interbank funds shrank notably, and at the end of the year the ECB adopted another set of non-standard measures to ease pressure on interbank markets. Slovenian banks were highly affected be the limited supply of interbank funds, as Slovenia belongs in the group of euro area countries whose credit ratings declined more noticeably; the credit ratings of Slovenian banks were dropping as well, making access to fresh source of finance even more difficult.

Besides external factors, the supply of banks' sources of finance was also significantly affected by internal imbalances built up in the period of favourable economic trends. Owing to certain bad decisions in the past when they also financed projects that were not economically viable, Slovenian banks have to cope with a significant increase in the share of non-performing claims, one of the largest in the euro area.[2] In view of the deteriorating quality of their assets, banks thus intensified the creation of additional provisions and impairments, which reached the highest level to date. This deteriorated their balance sheets and additionally impeded the lending activity. Due to their low capital adequacy, banks have limited access to sources of finance and are unwilling to take on additional risks. The low capital adequacy of Slovenian banks is also indicated by stress test results, which show that two Slovenian banks recorded below-average results despite the recapitalisation. The recapitalisation alone failed to improve the situation in Slovenia's banking sector, given that both banks that were recapitalised last year already need fresh capital[3]. To increase the efficiency of the Slovenian economy, it is therefore essential, in our view, to improve the governance of banks and other companies.

The limiting factors on the side of demand for loans strengthened in 2011. Slovenian companies and non-monetary financial institutions (NFIs) are highly dependent on debt sources of finance and are among the most

[1] In 2011, only Greece and Portugal recorded a larger real decline of GDP than Slovenia.
[2] A somewhat higher increase then in Slovenia was recorded only in Greece and Ireland.
[3] An additional recapitalisation of the NLB is also required by regulators.

indebted in the euro area. Despite companies' best efforts to deleverage, corporate indebtedness did not decline significantly by 2010. In 2011 it even grew, almost reaching the record levels in 2008. The increase was thus primarily a consequence of a further shrinkage of corporate and NFI assets due to the negative movements on capital markets. On the other hand, companies and NFIs increased the volume of loans, despite a significant reduction of their liabilities to banks. According to our estimate, this is also attributable to increased inter-company financing, which partly offsets the shortage of bank loans. The risk of balance sheet deterioration due to excessive exposure is thus being transferred to companies and NFIs. The problem of overindebtedness of Slovenia's economy is compounded by companies' poor business results coupled with their inability to generate internal sources of finance and a higher burden on the free cash flow. In the second half of the year economic activity shrank, which also impaired loan demand. Household borrowing, still relatively high in 2010, also slowed significantly, which we estimate is a result of poor labour market conditions, lower lending capacity and a high level of uncertainty on the real estate market.

Despite the ECB's measures, banks thus remain averse to taking additional risks. They mainly invest free assets in the financing of the government, which is in urgent need of funds because of the high public finance deficit. Since the second half of last year, the government has been (due to the limited access to funds on the euro area bond market) borrowing only on the domestic market, by issuing long-term treasury bills. The share of debt securities of domestic nonbanking sectors, most of which are government securities, grew by EUR 1.1 bn in the last six months[4] (despite the maturity of the government bond in the amount of EUR 1 bn[5]). As banks can pledge government securities for refinancing with the ECB, this type of borrowing does not have a significant impact on the liquidity of the banking sector. However, these operations are not without risk, as with a possible further decline in Slovenia's credit rating Slovenian government securities may no longer be accepted as collateral to secure loans from the ECB. Besides, the non-standard measures taken by the ECB are only temporary.

We estimate that one of the main problems in the Slovenian financial system is corporate governance of capital investments. After three years of a rapid deterioration of the quality of assets, the investment portfolio has not been cleaned up yet. According to our estimate, on one hand, this is a consequence of the inefficiency of the Slovenian legal system and its lengthy bankruptcy proceedings, which allow additional attrition of ailing enterprises, and on the other, the high degree of state involvement in the economy, which prevents the governance of investments according to economic criteria. Another deficiency is insufficient monitoring of debtors' operations as banks become aware of debtors' problems only when they fail to discharge their liabilities. At that point it is usually already too late as in most cases banks are among the last in the line of entities to face delays in payments by ailing companies.

---

[4] In the last quarter of 2011 and in the first quarter of this year.

[5] Based on balance sheet data we estimate that Slovenian banks owned around EUR 300 m in matured bonds.