INTERNATIONAL MONETARY FUND

Staff Country Reports

September 2001
IMF Country Report No. 01/161

Republic of Slovenia: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Banking Supervision, Securities Regulation, Insurance Supervision, and Payment Systems

The Financial System Stability Assessment on the **Republic of Slovenia** was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **April 20, 2001.** The views expressed in this document are those of the staff team and do not necessary reflect the views of the government of the **Republic of Slovenia** or the Executive Board of the IMF.

The policy of publication of staff reports and other documents by the IMF allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to Publicationpolicy@imf.org.

Copies of this report are available to the public from
International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623 7430 • Telefax: (202) 623 7201
E-mail: publications@imf.org • Internet: http://www.imf.org

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

REPUBLIC OF SLOVENIA

Financial System Stability Assessment

Prepared by Monetary and Exchange Affairs Department and European I Department

Approved by Stefan Ingves and Michael C. Deppler

April 20, 2001

- The Financial System Stability Assessment is based on the work of the joint IMF-World Bank mission that visited Ljubljana under the Financial Sector Assessment Program (FSAP) during November 6-20, 2000. The mission met the Governor of the Bank of Slovenia (BoS) and his senior management team (including senior officers in the areas of banking supervision, monetary management and operations, payments and research). The mission also met senior officials of the Ministries of Finance, Economic Affairs, Labor, and senior officers of the judiciary and legal system, the Securities Market Agency, the Insurance Supervisory Agency, the Central Securities Clearing Corporation. In addition, the mission had extensive discussions with representatives of the banking and insurance industries, capital markets and the private sector. Follow-up meetings were held with the authorities on February 8-9, 2001 in the context of the 2000 Article IV consultation mission. The FSAP team was led by David Marston (IMF) and comprised Hormoz Aghdaey (Deputy Mission Chief), Winfrid Blaschke, Haizhou Huang, Magally Bernal (Administrative Assistant) (all MAE), Agnes Belaisch (EU1), Rodney Lester, Melinda Roth, Peter Kyle, Kenneth Mwenda (all World Bank), Marcel Maes (Belgian Banking Commission-retired), Con Horan (Central Bank of Ireland), and Karsten Biltoft (Danmarks Nationalbank).

- Consistently good economic performance during the 1990s, improvements in regulatory and supervisory arrangements, and a program of rehabilitation have produced a sound and largely well-capitalized banking system, that appears robust to a range of external shocks and does not create significant macroeconomic risk. However, the system has evolved in a largely protected environment, in which limited competition has inhibited consolidation, and is still dominated by state-owned banks. The ongoing capital account liberalization and process of integration in the international capital markets will test the system. Despite a strong supervisory framework, important gaps exist in the areas of connected lending, consolidated supervision, and investment guidelines for insurance intermediaries. These could undermine governance and increase risks during the process of capital account liberalization. Money markets are underdeveloped due to structural rigidities and the design of BoS monetary instruments, and tax policy is limiting the expansion of the capital market and nonbank financial intermediaries. The authorities broadly agreed with the mission's assessment and have developed a comprehensive, time-bound action plan to address the outstanding issues.

- The first part of this report presents the main findings and overall assessment. The second part provides summary assessments of observance of standards and codes in banking supervision, securities and insurance supervision, and payments system as background to the overall assessment.

- The main authors are David Marston, Winfrid Blaschke and Agnès Belaisch (all IMF).

Contents Page

Section I. Staff Report on Financial Sector Issues 4

I. Executive Summary and Overall Stability Assessment 4
A. Financial System Soundness 5
B. Prudential Oversight and Liquidity Management Infrastructure 6
C. Directions for Reform 7

II. Macroprudential Environment and Overview of Financial System 8

III. Financial System Vulnerabilities 13
A. Banking System 13
B. Liquidity Management 21
C. Clearing and Settlements System 22
D. The Nonbank Financial Sector 23

IV. Legal and Supervisory Framework 26

Section II. Observance of Financial System Standards and Codes 29

I. Introduction and Summary 29

II. Basel Core Principles for Effective Banking Supervision 30

III. Assessment of IOSCO Objectives and Principles for Securities Regulation 35

IV. Assessment of IAIS Insurance Supervisory Principles 39

V. Assessment of Core Principles for Systemically Important Payments Systems 43

Text Tables

1. Financial System Structure 12
2. Measures of Financial System Interconnectedness 13
3. CAMELS Indicators 15
4. Indicators of the Performance of Various Banking Systems, 1997 18
5a. Stress Test for Foreign Exchange Risk 20
5b. Stress Test for Credit Risk 20
5c: Stress Tests for Equity Price Decline...20
6. Basel Core Principles: Reform Focus and Action Plan. 34
7. Implementation of IOSCO Objectives and Principles 38
8 Observance of IAIS Insurance Supervisory Principles..42
9. Compliance with the CPSS Core Principles for Systemically Important
Payment Systems 46

Figures

1: Banking Sector Distribution of Balance Sheet Indicators 16
2: Stress Test: Deterioration in Credit Quality...19

Boxes

1. The Authorities' Financial Sector Action Plan...8
2. Capital Account Liberalization...11

SECTION I—STAFF REPORT ON FINANCIAL SECTOR ISSUES

I. EXECUTIVE SUMMARY AND OVERALL STABILITY ASSESSMENT

1. **The Slovene financial system displays considerable institutional strength.** Following the breakup of the former SFRY in 1991, the loss of part of its asset base, a downturn in economic activity, and the attendant sharp deterioration in asset quality, the system went through a process of rehabilitation. This, together with consistently good economic performance and continuous improvements in the regulatory and supervisory arrangements during the last decade, has produced a sound and largely well-capitalized banking system, whose performance today compares favorably with that in selected EU and Central European comparator countries. Notwithstanding weaknesses in individual areas, the state of solvency and the general health of the financial system do not pose significant macroeconomic risks. Conversely, the system appears to be robust to a range of likely macroeconomic shocks.

2. **However, the system grew in a largely protected environment and is highly interconnected.** Limits on foreign participation in banks were relaxed only a few years ago, and capital controls on short-term (less than six months' maturity) capital movements are still in effect. Slovene banks have historically been operating with large interest margins, arising from deposit rate fixing arrangements among banks (in place until recently); the asymmetric impact of inflation and inflation indexation of financial contracts on their balance sheet; and the ready availability of high-yield, risk-free Bank of Slovenia (BoS) securities. These devices have provided a guaranteed source of profits to banks, thereby boosting their capital base but blunting the incentive to compete and consolidate. Also, while reasonable foreign exchange and risk management systems are generally in place in commercial banks, the modalities of the BoS's foreign exchange liquidity requirements and a contingency liquidity requirement agreement between the BoS and banks may have held back their development. Moreover, the Slovene financial system is highly interconnected, with myriad cross-sectoral shareholdings and significant cross-sectoral financial flows. This can be a source of systemic strength and resilience if all segments of the financial system are sound, but could also amplify risk and facilitate contagion if market segments are vulnerable. Finally, the unequal tax treatment of financial saving instruments and the lingering privatization gap have constrained the development of the capital market and nonbank financial intermediaries.

3. **While none of these facts undermine the soundness or detract from the broad achievements of the system, the ongoing capital account liberalization and deepening integration in the international financial market will test its efficiency and resilience.** The abolition of barriers to entry for foreign banks has already paved the way for foreign competition. However, given the small size of the Slovene market, its impact has so far been—and will probably continue to be—negligible. Much more important has been the effect of capital account liberalization, as corporations have started increasingly borrowing abroad at longer maturities and better terms, already squeezing bank profit margins. Unless the present rigidities in the Slovene capital market are addressed and the high interest

margins reduced, this process will result in client segmentation, with good clients that have access to foreign credit going abroad, and domestic banks being limited to higher-risk clients. This would undermine the quality of Slovene banks' assets, stunt the further development of the sector and, more broadly, limit the benefits of financial intermediation for the economy as a whole.

A. Financial System Soundness

4. **The banking system is generally robust and resilient to a range of macroeconomic shocks, but its current sources of profits will be challenged by capital account liberalization.** Stress tests indicate that real sector shocks that could lead to a deterioration in credit quality can be absorbed, due to existing high levels of provisions and the large system-wide capital base. For the same reason, the system could also withstand a sudden moderate appreciation or depreciation of the exchange rate. However, the profitability of the banks depends significantly on high interest margins, which will be progressively challenged as capital account liberalization forces margins to adjust gradually to European levels.[1]

5. **Insurance intermediaries are well-established and the dominant player has acceptable levels of capitalization, but investment practices are currently unregulated.** Bank deposits and bank bonds have represented up to 50 percent of insurance company assets in recent years, and a transition needs to be planned—and agreed with the insurance supervisor—in order that EU investment guidelines are achieved without significant disruption. The need for investment regulation to contain asset concentration is amplified by the increasing provision by some insurers of credit insurance for products offered by banks.

6. **Pension reforms have started, but may not be sufficient to guarantee long-term sustainability.** The system is actuarially imbalanced and can only be maintained with budgetary support of around 4 percent of GDP each year, over and above combined employer and employee contribution rates. Due to Slovenia's demographics, the age dependency ratio is projected to deteriorate in the long run. In order to contain the budgetary burden of the system, the costs of the first pillar are to be reduced through changes in benefit accrual rates and in other parameters. However, these reforms are to take effect only gradually, and more comprehensive reform may be needed to ensure continued sustainability beyond the end of this decade.

7. **The regulatory framework and infrastructure of the capital market are well developed, although liquidity is thin**. While there are no systemic risk implications in this

---

[1] The fragility of profits and need for efficiencies is evidenced by the fact that four banks currently report losses. Moreover, despite high margins, net interest income after tax for the system, is on average less than 1 percent of total assets.

sector, the thin liquidity and low level of development of nonbank financial intermediaries put more stress on the banking system and does not provide sufficient risk diversification.

B. Prudential Oversight and Liquidity Management Infrastructure

8. **Over the last decade, the legal framework governing the regulation and supervision of the financial sector has undergone significant reform**. The objective has been to make the applicable laws and regulations, as well as supervisory practices, consistent with international best practice and EU directives. The framework governing bankruptcy procedures, prevention of money laundering and financial system abuse is strong and comprehensive and, despite delays, regulatory arrangements affecting collateral and security enforcement are adequate.

9. **Slovenia complies with most of the Basel Core Principles for Effective Banking Supervision; however, there are important gaps to be addressed**. The absence of supervision on a consolidated basis and inadequate regulations on and oversight of connected lending and large exposures are particularly important given the high degree of interconnectedness of the financial system.

10. **The new Insurance Act, despite being based largely on the current EU directives, does not ensure adherence to all the Core Principles of the IAIS**. Arrangements for licensing, corporate governance, and internal control need to be strengthened. Moreover, the new Act does not adequately address credit risk, and the absence of current investment guidelines—and hence the temporary regulatory void in this area—is serious in light of the interconnectedness of the system.

11. **The Principles of Securities Regulation of IOSCO are largely implemented.** Operational independence, powers, and oversight of self-regulatory organizations, arrangements for information sharing and cooperation and principles governing issuers, and secondary market arrangements are sound. However, the absence of a graduated corrective action framework and the limited scope for the supervisor to enforce penalties are of concern.

12. **Payment and settlements arrangements are largely robust and will be improved further with the completion of the migration of the system from the Agency for Payments to the financial sector**. The fragmentation of the retail payment system and the absence of a national clearinghouse need to be taken up in the context of a Payments System Council. In the near-term, the transition from the Agency to the new system needs to be managed carefully to avoid risks arising from: (i) the difficulties of liquidity management for banks; (ii) the operational risks associated with end-of-day closing; and (iii) settlement risk arising from providing real-time access to funds with an-end-of day settlement in the Agency.

13. **The current liquidity arrangements are weak, hampering the ability of banks to manage liquidity shocks and risk, and reducing the effectiveness of monetary policy.** Existing arrangements have evolved to address various stresses in the past, but in the new

environment of a liberalized capital account they constrain market development and inhibit the capacity for effective signaling by the BoS of its policy intentions. The latter has potential macroeconomic consequences. These weaknesses have to some extent been masked by the conditions of sustained excess liquidity.

C. Directions for Reform

14. While there are no indications of imminent insolvency or significant systemic risk, the report suggests prospective areas for strengthening the financial system and improving its resilience. During the discussions with the authorities, the mission emphasized the following broad themes.

- **Increasing competition** through privatizing the two state-owned banks, divesting the government shares in insurance companies, de-indexing financial contracts, and equalizing the tax treatment of different savings instruments.

- **Strengthening supervision,** especially in light of system interconnectedness, through supervising institutions on the basis of consolidated accounts, with special attention to related party lending, especially to shareholders; strengthening cross-sectoral supervisory cooperation; and filling the regulatory gap arising from the absence of investment guidelines for the insurance sector.

- **Enhancing the scope for risk management at commercial banks** by gradually reducing the foreign currency minimum requirement or replacing it with requirements on currency and maturity matching; and applying a uniform reserve requirement across maturities and remunerating it at a market-related interest rate.

- **Improving the liquidity management infrastructure and developing the money market** through replacing BoS's current placement of its bills on tap with an auction; rationalizing its standing facilities; and establishing allocation limits in the primary auction and opening it to a wide range of participants outside the financial sector.

- **Developing the nonbank financial sector** through filling the privatization gap and recapitalizing the privatization investment funds, and ensuring that the planned transformation of these funds into regular open-ended mutual funds proceeds smoothly and does not generate instability in the stock market. This is also part of the rationale behind equalizing the tax treatment of different savings instruments.

15. **The authorities broadly agreed with the conclusions of the mission, and prepared a comprehensive and detailed Action Plan to address the identified shortcomings.** The Action Plan was presented by the authorities and discussed with the staff in the context of the 2000 Article IV consultation discussions. The Plan reaffirms their

commitment to capital account liberalization and includes specific steps addressing all the main issues identified by the mission. The broad elements of the action plan are summarized in Box 1, and details are discussed in each of the sections of the paper.

Box 1. The Authorities' Financial Sector Action Plan

Strengthening prudential oversight. Consolidated supervision will be conducted over the different holdings of financial intermediaries by end-2001. Memoranda of Understanding will formalize cross-border coordination with foreign supervisors. The law will be amended to address issues of connected lending and exposure to shareholders. Shareholders acquiring a qualifying share in banks will be required to have appropriate expertise in banking business. Licensing requirements for financial institutions will be tightened. The Insurance Law will be amended to address investment policies. Supervisors will receive regular training to upgrade expertise in new banking activities and supervisory frameworks.

Improving risk management in banks. Banks will be encouraged to develop their own internal models, following standards prepared by supervisors, to assess credit and market risks and set capital requirements to cover them.

Improving liquidity management. The BoS will rationalize the multitude of intervention instruments so that they reflect liquidity conditions in the market and enhance policy transmission through interest rates. Specifically, the tap placement of BoS bills will be replaced by auctions open to a wide range of participants; the reserve requirement will be made uniform across maturities and remunerated at market-related rates; the foreign currency liquidity requirement will be replaced by rules on currency and maturity matching. Also, the BoS and the Ministry of Finance are jointly to develop a government securities market that will generate a benchmark yield curve for the pricing of other assets.

Completing the reform of the payments system. After-hours money market rules will be modified to reduce settlement risk and facilitate the transition to the new RTGS system.

II. Macroprudential Environment and Overview of the Financial System

16. **Benefiting from a favorable starting position, Slovenia has successfully achieved its transition to a functioning market economy during the years since independence**. It has a stable macroeconomic environment with sustainable growth, the highest standards of living and investment ratings among central and east European countries, and has made significant progress towards convergence with the EU, with which it has started membership negotiations. Initial conditions helped Slovenia recover from the collapse of output associated with the dissolution of the former Yugoslavia: it was the wealthiest and most outward-looking region of the federation, conducting above two-thirds of its trade with Western Europe. But a key factor behind this success has been the adoption by the government of conservative economic policies aiming at ensuring internal and external stability, while undertaking in a gradual manner the necessary reforms to transform Slovenia into a competitive, market-oriented economy.

17. **Economic performance was strong in 2000, but inflation persistence is becoming a problem.** At 4.8 percent, growth was strong and, despite a deterioration in the terms of trade, the current account deficit was reduced in 2000. Inflation, however, has remained high even after the impact of price shocks (introduction of VAT in July 1999 and oil price increases) had lapsed. Uncertainty about inflation and exchange rate developments led to a rise in currency substitution (the share of foreign currency deposits in broad money has grown from 26 percent at end-1999 to about 30 percent by end-2000).

18. **The particular history and circumstances of Slovenia's transition to a modern market economy have affected the present-day shape of the financial system.**

- After the break up of the Socialist Federal Republic of Yugoslavia (SFRY) in 1991, the Slovene banking system was concentrated, had lost part of its asset base[2] and, with the downturn in the economy, experienced a sharp deterioration in the quality of its loan portfolio. The rehabilitation of the banking system during the next few years[3] resulted in a significant improvement of the financial position of the major Slovene banks, but brought about even greater concentration: **the banking system became dominated by three large banks** (two of which are still state-owned), with over 50 percent of assets and about 50 percent of the market for loans and deposits.

- The memories of hyperinflation in the years around independence (inflation reached 13,000 percent per annum in late 1989) limited central bank credibility and lowered the population's readiness to internalize disinflation gains in its expectations of future inflation. To boost confidence in the currency and broaden the time horizon with which the public would feel comfortable in making price predictions, **widespread indexation** was introduced in the economy, including for most financial contracts. To this day, interest rates for households and enterprises are quoted in real terms, and a separate, published revaluation clause (or TOM) is added to compensate for past inflation.[4]

- In the early years of transition, the aggressive pricing behavior of smaller banks to attract deposits and expand their lending base resulted in high lending rates in the system as a whole. In 1995, in an effort to bring down interest rates, the BoS brokered an **interbank**

---

[2] Slovene banks' foreign currency deposits placed at the former SFRY central bank were confiscated and assets held in other republics of the federation were frozen.

[3] Banks' non-performing assets and contingent liabilities were exchanged for bonds issued by the Bank Rehabilitation Agency. A total of bonds of just under 10 percent of 1993 GDP were issued.

[4] The number of previous months included in the revaluation clause, also called the *basic rate* (in Slovene, TOM: *temeljna obrestna mera*), has changed over time; it is currently twelve months.

agreement capping deposit rates. Despite the abolition of this "gentlemen's agreement" in March 1999, the Bankers' Association continued to recommend a schedule of maximum interest rates on deposits for the system as a whole until the end of 2000.

- The process of **ownership transformation** of socially owned enterprises, inherited from the former SFRY, excluded insurance, banks in rehabilitation, loss-makers, and firms belonging to particular sectors of activity. It involved the distribution of vouchers to the population, which could be later exchanged for shares in the capital of **privatization investment funds**. The funds used the vouchers to obtain the shares of socially owned enterprises earmarked for them. However, the value of the vouchers exceeded that of the available social capital so that, to date, about 30 percent of the funds' assets are held in vouchers with no assigned counterpart.

- From the outset of transition, monetary policy was oriented towards restoring the public's confidence in the currency. Slovenia chose a flexible exchange rate regime and monetary targeting. The BoS had to operate this policy framework in a difficult environment, due to the large degree of currency substitution and a relatively underdeveloped financial market. As a result, it relied extensively on **direct intervention** in the foreign exchange market, **sterilization** through the use of central bank bills, and **restrictions on capital flows**.

19. **In the future, the liberalization of the capital account (Box 2), albeit beneficial for the economy, will challenge the system.** The abolition of the ban of foreign borrowing by corporates in February 1999 resulted in an increasing substitution of debt held with domestic banks for debt contracted abroad, where long-term interest rates are lower than in Slovenia. If Slovene banks do not adjust lending rates competitively, one of their traditional income sources would be at risk. The restriction on firms' ability to open an account abroad, expected to be abolished in mid-2001, could further reduce Slovene banks' fees earned on account management and exchange rate operations. The impact of capital account liberalization on the Slovene financial system will thus not be abrupt but rather gradual, as measures already taken begin to affect the economy, and agents adjust to the new environment. Nevertheless, this impact overtime will be significant, and banks and other financial intermediaries will have to adjust. The exigencies of this adjustment process will be a major challenge for the system as a whole.

Box 2. Capital Account Liberalization

Recent measures: In 1999–2000, restrictions on foreign branch banking were removed; controls on portfolio inflows were gradually relaxed; the 40 percent foreign exchange surrender requirement on foreign loans was eliminated; and enterprises were allowed to hold foreign currency accounts in domestic banks (individual accounts were already allowed). On January 1, 2001, restrictions on portfolio inflows with maturity of 6 months or more were eliminated.

Current status: There are no controls on foreign investment except for portfolio flows with maturity of less than 6 months. For residents, the only remaining restriction is the prohibition to keep bank accounts or purchase securities abroad. In addition, the Bank of Slovenia preserves the right to impose temporary restrictions for up to 6 months in the event of large capital movements that could jeopardize the monetary and exchange rate policy framework.

Plans: The Bank of Slovenia plans to remove the restriction on enterprises to open accounts abroad by mid-2001, remaining restrictions on portfolio inflows by year end; and all other restrictions by the time of EU accession.

Structure of the Financial System

20. **This legacy has shaped the current financial system and its infrastructure.** The financial system in Slovenia comprises 25 commercial banks, 4 savings banks, 68 savings and loan undertakings, 42 brokerage houses and 17 insurance companies, including 3 reinsurers and 19 mutual funds (Table 1). In addition, a number of authorized investment companies operates in Slovenia. Supervision of the system is effected through the BoS for commercial and savings banks; the Securities Market Agency for brokerage houses, investment funds and the Ljubljana Stock Exchange (LJSE); and the Insurance Supervisory Agency for insurance companies and pensions.

21. **The banking sector in Slovenia is relatively concentrated, with 3 banks accounting for approximately 50 percent of banking assets.**[5] Competition is low and banks enjoy comfortable margins, partly the result of the agreement on deposit rate ceilings (until end-2000), and partly the effect of the asymmetric application of the TOM to financial contracts in the presence of inflation, and the ready availability of risk-free BoS securities offered to banks to achieve monetary policy objectives. An important role is played by the state-owned banks—Nova Ljubljanska Banka (NLB) and Nova Kreditna Banka Maribor (NKBM)—which are also the country's two largest banks.

22. **Tax policy and the process of ownership transformation have not facilitated a rapid development of other types of financial institutions that could compete with banks and deepen financial intermediation.** Preferential tax treatment of deposit interest income has kept the capital market at a state of infancy. The securities market in Slovenia is

[5] The largest five banks account, on a consolidated basis, for about 70 percent of the sector's assets.

thin, and the capacity for resource mobilization by corporates and risk mitigation through nonbank financial institutions is small. Turnover on the Ljubljana Stock Exchange (LJSE) has been limited, with low overall stock market capitalization, despite substantial growth in recent years. Market capitalization, including the official and free markets for both equities and bonds, stood at SIT1138 billion (or 28 percent of GDP) at end-2000. The LJSE trades equities and bonds, as well as shares of privatization investment funds. The debt securities market is dominated by BoS bills. By early 2000, some 216 companies and investment funds were trading at the LJSE. However, around 70 percent of the turnover in the official market was accounted for by five companies. Investment fund assets are about 16.5 percent of GDP, including unutilized privatization vouchers that average 31 percent of total funds.

Table 1. Financial System Structure

	Number of Institutions					Total Assets	
						(SIT billions)	(In percent of GDP)
	Dec 31 1995	Dec 31 1996	Dec 31 1997	Dec 31 1998	Dec 31 1999	Dec 31 1999	Dec 31 1999
Banks	33	31	28	24	25	2,687.6	73.7
Savings banks	10	7	6	6	6	11.0	0.3
Savings & loan institutions	72	71	70	70	68	55.0	1.5
Brokerage houses*	44	46	43	42	42	653.0	18.0
Management companies	28	26	26	23	22	n.a.	n.a.
Authorized investment funds	68	72	60	46	46	599.0	16.5
Mutual funds	18	15	15	15	17	8.7	0.2
Insurance companies	12	12	13	13	13	222.6	6.1
Reinsurance companies	2	2	2	3	3	41.9	1.1

* Includes 10 banks authorized to carry out trading operations.
(Assets include SIT116.9 billion in own account, 19.2 billion under management, and 516.9 billion in investments on account of third parties.)

Memo items:						Share of Baking System Assets (Percent)
State-owned banks	3	3	3	3	3	41
Foreign-owned banks	6	4	4	3	5	5

Source: *Bank of Slovenia.*

23. **Insurance penetration, expressed in terms of premium-to-GDP, is the highest in central and eastern European transition countries.** The Slovene insurance market mobilized total premium revenue in 1999 of SIT169.4 billion (US$700 million). The market is dominated by the state-owned company Triglav, which on average accounts for about half of life and non-life premium incomes.

24. **The financial system is highly interconnected.** Within the banking system, equity participations and strategic relationships are extensive. Across sectors, there is a myriad of cross-shareholdings, especially between the banking and insurance sectors. Moreover, many privatization investment funds hold significant interest in the insurance sector and several funds are, in turn, managed by commercial banks. In addition, financial flows between the banking and insurance sectors are important. Deposits of the overall insurance sector account for 6 percent of tolar deposits in the banking system, 40 percent of which is in three banks (Table 2). The portfolio concentration is in part the result of the underdevelopment of capital markets and, until recently, of controls to foreign capital flows.

Table 2. Measures of Financial System Interconnectedness

1. Banking system exposure to shareholders	Percent of capital
• On-balance sheet	58.6
• Off-balance sheet	20.8
2. Banking system equity investments in:	
• Financial institutions	17.3
• Nonfinancial institutions	9.1
3. Banking system exposure to insurance sector	
• Credit	1.4
• Equity and others	3.2
4. Insurance sector deposits in banking system	28.8

Source: *Bank of Slovenia.*

25. **Within the banking system, interbank activity is low but exposure to shareholders significant.** Annual turnover ratios on the interbank market are below the system's deposit base, due to conditions of excess liquidity and the dominant presence of the BoS in supplying liquidity. While system-wide the distribution of credit by sector is well diversified, some individual banks, especially smaller and regional ones, are dependent on a few large borrowers. Bank exposures to related parties on average exceeded 15 percent of capital for the top 5 banks and on- and off-balance sheet exposure to shareholders amounted to 19 percent in 1999.

III. Financial System Vulnerabilities

A. Banking System

26. The recent performance of the banking system was reviewed using a CAMELS approach, i.e., using indicators of capital adequacy, asset quality, management quality, earnings, liquidity, and sensitivity to market risk. Credit ratings were also considered, as a

market based indicator. The results are reviewed in Table 3 and the CAMEL distribution in percentiles is shown in Figure 1.

CAMELS Review and Market Indicators

27. **The CAMELS review suggests a largely well-capitalized and liquid banking system, with moderate profitability.** The aggregate risk-based capital ratio of the Slovene banking system, calculated on an unconsolidated basis, is currently around 13.6 percent for Tier I&II capital.[6] Earnings indicators are less robust in aggregate, and return on assets (ROA), as measured by the ratio of after-tax profits to average total assets, have remained fairly stable over the last few years, at around 0.5 percent. Return on equity (ROE) has also generally been stable around 6.3 percent. However, system-wide profitability is critically dependent on high net interest margins. Banks have a diversified sectoral lending profile and up to now generally manageable levels of nonperforming loans—the gross *nonperforming exposures ratio* stands, on a system-wide basis, at about 5 percent of total exposures—though with important outliers. Nevertheless, the high levels of connected lending—which in many banks exceed 25 percent—are a cause for concern. Moreover, there is evidence of increased foreign currency lending, in some cases to agents that do not generate foreign exchange income.[7] *Foreign currency lending* has been increasing and, for the first seven months of 2000, it accounted for almost half of the total loans and three quarters of long-term loans obtained by Slovene companies (net flows).[8]

---

[6] Capital ratios are supported by the large holdings of government and central bank paper, which are risk-weighted at 0 percent and a significant share (more than one third) of capital consists of revaluation reserves.

[7] Calculations by the BoS indicate that, in a few cases, industry sectors with low ex/import-to-GDP ratios have a surprisingly high share of foreign currency financing reaching up to 50 percent in some cases, even after correcting for foreign direct investment. Notwithstanding, these sectors account for a small share of total bank financing

[8] Indicators on the health of the *corporate sector*, especially debt-equity ratios, were analyzed for the largest stock exchange-traded corporates, using data for end-1999. The analysis suggests that, with some dispersion, debt-equity ratios range from lows of 10 percent through 140 percent. For long-term debt only, ratios range between 20-50 percent, especially for companies in wholesale and retail activity, which are high relative to international levels.

Table 3. CAMELS Indicators
(In percent)

CAMELS Indicators	1995	1996	1997	1998	1999	2000 (June 30)	2000 (Projected)
CAPITAL ADEQUACY							
Tier-1 ratio	18.9	17.5	16.9	14.9	13.9	13.5	13.1
Tier-1&2 ratio	20.8	19.0	18.2	15.3	14.0	14.0	14.0
ASSETS							
Share of exposures per risk weighting (RW) category:							
RW = 0%	20	n.a.	n.a.	n.a.	40	39	n.a.
RW = 20%	41	n.a.	n.a.	n.a.	11	12	n.a.
RW = 50%	5	n.a.	n.a.	n.a.	6	5	n.a.
RW = 100%	35	n.a.	n.a.	n.a.	43	44	n.a.
Total exposures/assets	118	117	115	118	118	119	119
Sectoral concentration of exposures							
Government & Defense	16	16	15	13	13	13	12
Financial (incl. BoS)	14	15	21	18	16	16	16
Manufacturing	15	14	13	14	13	14	14
Trading	8	8	9	10	11	11	11
Construction	2	2	2	3	3	3	3
Utilities	3	3	3	4	4	3	2
Foreign currency lending							
Share of FX lending	19	15	13	15	16	16	n.a.
Nonperforming exposures (NPE)							
Share of gross NPE	5.7	6.2	5.4	5.3	5.1	5.1	n.a.
Share of net NPE	5.7	6.2	1.5	1.5	0.8	0.8	n.a.
MANAGEMENT							
Expenses/revenues	58	55	57	60	62	56	n.a.
Earnings/employee (million SIT)	1.21	1.53	1.47	1.55	0.96	1.60	n.a.
EARNINGS							
Return on assets (ROA)							
Profits I	n.a.	2.6	2.3	2.0	1.8	1.1	2.0
Profits II	n.a.	1.1	1.1	1.2	0.8	0.6	1.1
Profits III	n.a.	1.0	0.8	0.7	0.4	0.6	0.5
Total income	n.a.	5.7	5.4	5.1	4.8	2.5	4.6
Total expenses	n.a.	3.1	3.1	3.0	3.0	1.4	2.5
Return on equity (ROE)							
Profits I	n.a.	24.2	22.0	19.8	18.3	11.6	23.6
Profits II	n.a.	10.6	10.7	11.5	7.9	6.2	12.7
Profits III	n.a.	9.1	7.8	7.1	3.9	6.2	6.4
Total income	n.a.	53.2	51.5	48.9	47.5	26.1	53.2
Total expenses	n.a.	29.1	29.5	29.1	29.2	14.5	29.6
Profits I: Total expenses minus total income							
Profits II: Profits I - specific provisions – Fund for General Banking Risk							
Profits III: Profits II – tax - extraordinary items							
LIQUIDITY							
Liquid assets/demand depos	21.7	17.7	23.4	26.8	25.9	24.3	n.a.
Demand depos/liabilities	28.6	28.8	28.7	27.1	28.1	27.6	n.a.
SENSITIVITY TO MARKET RISK							
Foreign exchange risk							
Net FX position/capital	n.a.	n.a.	n.a.	0	-5	-20	-18

Source: Bank of Slovenia.

Figure 1. Banking Sector Distribution of Balance Sheet Indicators

Figure 1a. Capital Ratios

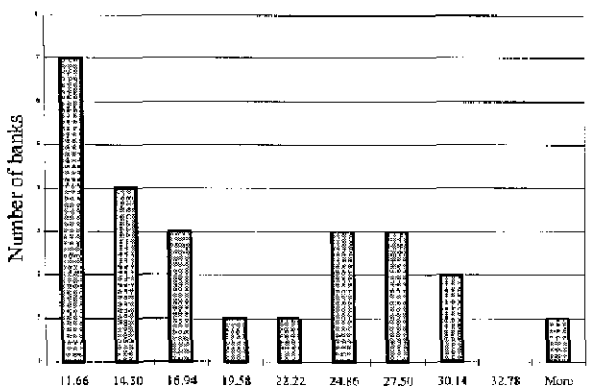


Figure 1b. Nonperforming Exposure Ratios

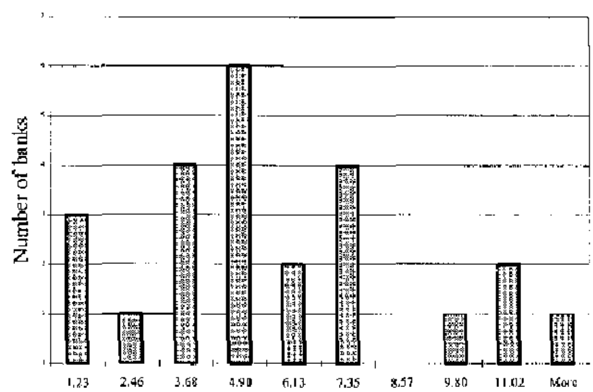


Figure 1c. Oper. Costs/Aveg. Total Assets

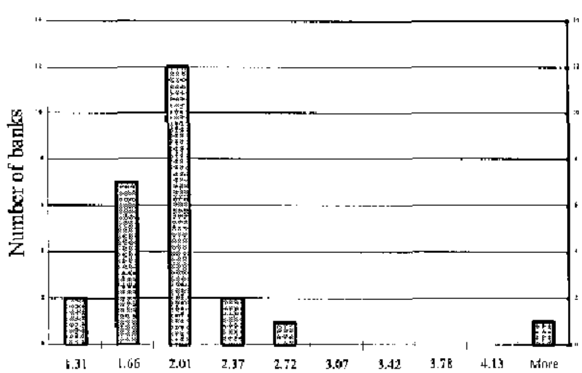


Figure 1d: ROA

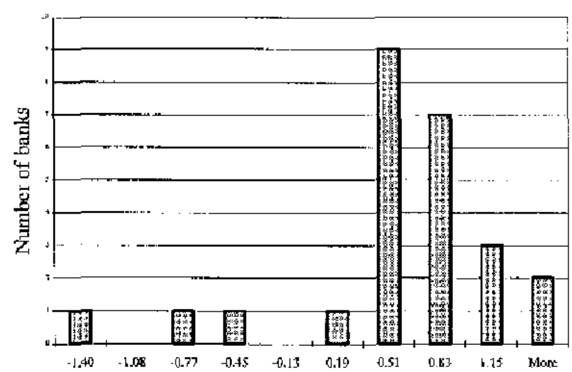
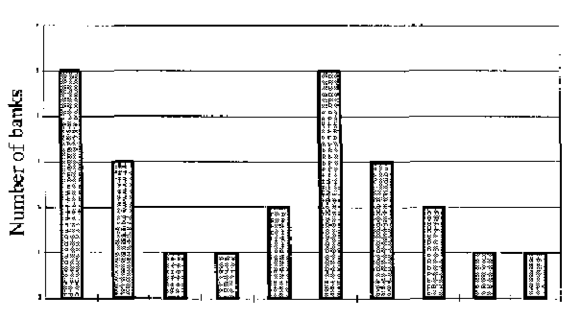


Figure 1e. Volatile Deposit Ratios



Source: Bank of Slovenia and Fund staff estimates.

28. **Over the past 2½ years, the mean ratio of average volatile liabilities on demand to average liabilities has remained rather stable, staying within a range of 16 to 17 17 percent.** Foreign exchange risks are moderated by the simultaneous application of exposure limits, capital charges, and foreign exchange minimum requirements. Interest rate risk in tolars is limited by the short-term nature of tolar loans.

29. **Table 4 compares the Slovene banking system with a reference group of select EU and central & eastern European countries.** Performance indicators suggest that Slovene banks compare favorably with the reference group (reference data for 1997), despite declining indicators of profit in the most recent years. Both operating income to expenses and operating expenses to total asset ratios suggest relative efficiency vis-à-vis the reference group and risk measures are in broadly in line with peers. Slovenia's *sovereign ratings* are at investment grade level, with long-term foreign currency ratings of single-A from Standard & Poor's (since 1996), and A2 from Moody's (upgraded from A3 in November, 2000). The two largest banks (NLB and NKBM) hold *financial strength ratings* of D+ from Moody's, the highest rating assigned to banks in central and Eastern Europe.

Stress-Testing of the Banking System

30. **To assess the ability of the banking system to absorb macroeconomic shocks, stress tests simulating scenarios agreed with the authorities were performed on each of the largest 5 banks (representing approximately 65 percent of assets), yielding indicative results for the entire banking system** (Tables 5a-5c). It is important to note that this exercise is limited to estimating the direct, *first-round* impact of a shock on banks' portfolio. The final impact of each shock on banks and the financial system as a whole will likely be different, as it would also reflect feedback effects on the macroeconomy, second-round effects involving banks and other financial institutions, and the bank's own adjustment process. In addition, shocks can be compounded. The scenarios simulated were agreed with the authorities and included:

- A sudden, significant movement in the exchange rate (appreciation or depreciation), possibly arising from large and unexpected capital movements.
- A sudden deterioration in loan quality (possibly caused by a significant slowdown in activity), assessed using a credit migration matrix.
- A sudden, sharp decline in stock market prices.

31. **The tests reveal that the banking system is largely resilient to exchange rate shocks, while the effect of a general deterioration in credit quality would be manageable** (Figure 2), given the high levels of provisioning induced in part by favorable tax treatment. Nevertheless, this assessment needs to be interpreted with caution. The risks arising from large exposure to individual borrowers—common in many small banking systems—require additional investigation at the individual bank level, since their portfolio concentration may not be adequately captured by the transition matrices used in this exercise. For one thing, the share of loans is higher in smaller banks than in the larger ones (notably the state-owned banks), as the latter tend to hold large amounts of government bonds.

Table 4. Indicators of the Performance of Various Banking Systems, 1997

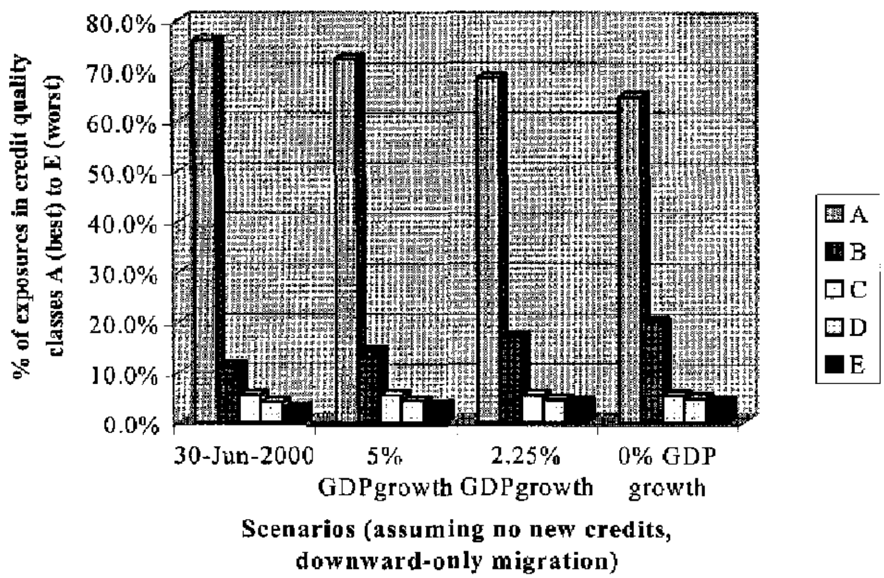
(In Percent)

	Performance Indices			Structure Indices	Operating Indices			Risk Indices		
	Net Interest Margin to total assets	RoE	RoA	Total Assets (mn USD)	Total income/ Operating Expenses	Operating income/Total expenses	Non-interest Income/ Operating Expenses	Loan Loss provision/ Total Credit 1/	Risk Weighted Assets Ratio	Capital Adequacy
Austria	1.52	9.4	0.4	473133	144.1	1.8	62.0	0.82	45.5	15.0
Belgium	1.07	15.1	0.4	791043	156.4	1.3	58.0	0.29	24.0	17.4
Czech Republic	2.54	-2.7	-0.3	67295	108.2	14.4	90.5	1.94	n.a.	n.a.
Greece	2.25	17.9	1.0	83872	158.2	2.8	78.3	1.78	47.7	n.a.
Hungary	4.32	12.1	1.5	27917	122.6	3.8	8.5	n.a.	50.7	22.1
Italy	2.39	5.0	0.3	1597647	144.8	2.3	42.0	1.36	53.5	13.0
Norway	2.41	13.3	0.9	133874	145.4	2.3	40.8	n.a.	77.8	12.4
Ref. group average	2.36	10.01	0.60	453540	139.97	4.11	54.30	1.24	49.88	16.00
Slovenia 1997	4.51	10.3	1.1	11952	175.6	3.1	39.4	1.55	54.2	19.0
Slovenia 1999	3.76	7.8	0.8	13659	162.5	3.0	44.8	1.70	57.3	14.0

1/ For Czech Republic and Hungary includes securities.

Source: Bank Profitability, OECD, Financial statements of banks, 1997, IFS and staff calculations.

Figure 2. Stress Test:Deterioration in Credit Quality



32. **The system also appears to be reasonably resilient to a sharp decline in equity prices, although the risks in this case may be compounded.** Calculations by the BoS—which also take into account banks' exposures to brokerage houses—suggest that a 25 percent fall in equity prices reduces the banking system's profits by two thirds (using data for 2000), with system-wide capital declining by 0.2 percentage points.[9] However, a sharp decline in equity prices may be accompanied by a deterioration in credit quality, thus compounding the risks analyzed in this and the previous stress test.

[9] The size of the simulated shock was chosen taking into account the difference between the historical high and low of the Slovene stock market.

Table 5a. Stress Test for Foreign Exchange Risk

Banking system:	Current Position	BoS simulation Depreciation by 20%	20% Open position Depreciation or appreciation by 20%
Capital Ratio	13.6%	13.5%	13.4%
Number of banks making annual profit or loss:			
Profit	21	22	
Loss	4	3	

Source: Bank of Slovenia, and Staff estimates.

Table 5b. Stress Test for Credit Risk

Banking system:	Current Position	BoS simulation	Staff simulation Credit migration matrix		
GDP growth rate	5%	0%	5%	2.25%	0%
Capital Ratio	13.6%	13.0%	13.0%	12.2%	11.3%
Number of banks making annual profit or loss:					
Profit	21	9			
Loss	4	16			

Source: Bank of Slovenia, Nova Ljubljanska Banka (NLB), and Staff estimates.

Table 5c: Stress Test for Equity Price Decline

	Current Position	Equity price fall by 25%
Largest banks:		(63% of system assets)
Capital ratio		Number of banks in different capital ratio brackets under each scenario
6%-8%	0	0
8%-10%	2	2
10%-15%	2	2
15%-30%	1	1
Banking system:		Number of banks making annual profit or loss under each scenario
Profit	21	17
Loss	4	8
Capital Ratio	13.6%	13.4%

Source: Bank of Slovenia.

B. Liquidity Management

33. **Arrangements for systemic liquidity management in Slovenia have been shaped by memories of hyperinflation, a bank failure in 1996, and an episode of large capital inflows in 1996-97, and are constrained by the small size and rigidities of the money market.** Although the overall monetary and exchange rate policy framework has worked well, delivering low inflation and increasing confidence in the currency, this legacy has resulted in a rather idiosyncratic approach to monetary management, involving indexation of financial contracts, high foreign exchange liquidity requirements, and (for most of the decade) a bank agreement on a schedule of deposit rates. The BoS regulates liquidity through primary and secondary operations in foreign exchange and tolar bills and a range of loan facilities. The experience with the bank failure led the BoS to establish a contingency liquidity mechanism, whereby commercial banks were required to provide collateral to a bank in a liquidity squeeze in order for it to qualify for last-resort lending by the BoS. More importantly, in case of foreign exchange intervention, the BoS has a contractual arrangement with participating banks requiring them to participate at the intervention rate, with excess liquidity absorbed through a standing swap facility.

34. **Despite a significant existing stock of liquid assets in the banking system, the liquidity management infrastructure has not really been tested.** The BoS (currently the only real counterpart in a liquidity crunch) offers and absorbs liquidity through a standing tap arrangement. About 44 percent of the holdings are concentrated in the three largest banks. The standing tap offers are at posted rates linked to international deposit rates, and it is not always clear how the rates on these operations reflect the monetary policy stance. Moreover, the standing arrangement for BoS bills reduces the prospect of market-making or secondary market activity.[10] The limited trading in the market exacerbates the impact of concentration, thereby making "liquid" assets less liquid in period of stress. This reality has been masked by the existence of excess liquidity conditions, with banks holding approximately 4 percent of excess reserves on average over the past year, resulting in interbank turnover ratios of less than 1 percent vis-à-vis the deposit base. Therefore, the capacity of the money market to handle real liquidity shocks has not really been tested.

35. **The transmission of monetary policy through interest rates is blunted by money market rigidities, the design of BoS's monetary policy instruments, and the indexation of most commercial bank deposits and loans.** The money market is distorted, with the largest bank in a chronic oligopsonistic position. Partly in response to this, the BoS has been providing an ample supply of liquidity instruments on tap, which limits the scope for signaling rapid changes in the policy stance through interest rates and concurrently reduces the role of market signals in policy formulation. Moreover, commercial bank interest rates are influenced by the TOM and—until recently—the bank agreement on deposit rates, none

---

[10] Since the BoS is always present in almost the full maturity spectrum and there is always full allocations to applicants at relatively stable yields, there is little incentive for bilateral market activity.

of which respond to BoS intervention. The combination of these factors has rendered policy transmission through interest rates slow and erratic.

36. **The ongoing capital account liberalization will challenge the current liquidity management infrastructure and operating framework for monetary policy.** While the current arrangements have been successful in an environment of pervasive capital controls, they may not be adequate once capital liberalization takes hold. Moreover, the current arrangements may not have the depth to recycle liquidity effectively in the event of liquidity stress. Finally, interest rates will become increasingly important in an environment of free capital flows, thus throwing the weakness of the interest rate transmission mechanism in sharp relief.

37. **The BoS's Action Plan includes a number of measures to address these shortcomings.** The BoS plans to rationalize the multitude of intervention instruments so that they reflect liquidity conditions in the market. Specifically, the tap placement of BoS bills will be replaced by auctions open to a wide range of participants; the reserve requirement will be made uniform across maturities and remunerated at market-related rates; the foreign currency liquidity requirement will be replaced by rules on currency and maturity matching. Also, the BoS and the Ministry of Finance are jointly to develop a government securities market that will generate a benchmark yield curve for the pricing of other assets. While the structure of the interbank market will inevitably remain oligopsonistic in the foreseeable future, these measures will improve its functioning and enhance policy transmission through interest rates.

C. Clearing and Settlements System

38. **The present clearing and settlements system in Slovenia is in transition from a system that relied on the Agency for Payments to a modern RTGS and Giro Clearing system.** The most important immediate task confronting the authorities is to keep the momentum and complete this process. Although the Agency for Payments is being phased out gradually, the co-existence of the old and the new system raises a number of questions regarding efficiency and risk containment. *First*, the present set-up renders it infeasible for banks to gain real-time information on their total liquidity. *Second,* the closing of the payment system at the end of the day entails operational risks for both participants and the BoS. *Third*, the settlement system at the Agency is inherently prone to carry more risk than many other systems, as the system gives legal entities real time access to funds but settlement takes place at the end of the day. And *fourth*, the settlement of the cash leg of securities transactions through accounts with the Agency also raises the risk of contagion from the Agency to the clearing and settlement of securities.

39. **The authorities are well aware of the risks during transition.** With a view to reducing these risks and preparing banks for the takeover of accounts of legal entities, since the second part of 1999 banks were made to maintain "shadow" accounts of selected legal entities. Considering that the corporate sector will also have to become familiar with new ways of handling payments and controlling liquidity, the project also enables legal entities

gradually to become used to the new environment and test their mechanisms of submitting payment orders with selected banks. Moreover, the authorities have launched an important initiative to create an Integrated Small Value Payments System (ISVPS), including a national payments council. Such a council would serve as the platform for dialogue between market participants and authorities on the broader issues in the development of the payments system. The establishment of an ISVPS could also help level the playing field among banks for the provision of payment services.

40. **Risk management will improve significantly as banks gain access to real time information on their liquidity position in the system.** After assessing the risks, the BoS may wish to consider allowing savings banks to offer payment services to all customers (including large corporates). Eventually, when savings co-operatives are also brought under sufficient supervision, the BoS may consider broadening the field of payment service providers further. Moreover, with a view to enhancing competition in capital markets, the BoS may also wish to consider giving brokers formalised access to settle the cash leg of securities deals through non-interest bearing accounts with the Bank. Finally, after completion of the transition period, the BoS may also consider providing intra-day credit against collateral.

D. The Nonbank Financial Sector

41. Nonbank institutions in Slovenia are small relative to banks. While not posing any immediate systemic risks—though risks arising from insurance companies' interrelations with banks should be carefully watched—their underdevelopment suggests that the this sector does not currently benefit from the full range of risk reduction and intermediation services that such markets provide.

Securities Markets

42. **The securities market is efficient and well-supervised, but it is small and there are various impediments to its development.** Oversight arrangements comply with most IOSCO principles. The market, however, suffers from a lack of liquidity and a dearth of domestic institutional investors, the result of a number of structural factors. First, an **uneven tax regime** discriminates against equity investment: capital gains and dividends are taxed, whereas household interest income on deposits is not. Second, **investment restrictions** disfavor the domestic market, as recent liberalizations allow Slovene investment in foreign securities but maintain restrictions on short-term foreign investments in Slovene securities. The **range of domestic institutional investors is limited**: the privatization investment funds have no liquidity themselves, the mutual fund industry is very small (2 percent of assets managed by all funds), and pension mutual funds have not yet started to operate. Individual investing has not yet developed in Slovenia, probably due to the tax environment. Moreover, **delays in privatization**, in particular of many of the blue chip stocks (i.e., two of the largest banks, telecoms) have kept the supply of good securities low.

43. **In the future, the market can be expected to grow, given the likely increase in both supply and demand.** The upcoming establishment of pension mutual funds, the planned transformation of the Privatization Investment Funds into open-ended mutual funds (see below), the continued growth in the regular mutual fund industry, as well as the likelihood of individual investment growth given the expansion of internet trading should all serve to increase demand for Slovene securities. Privatization of the remaining state-owned assets will increase supply. These developments should boost liquidity in the capital market and spur the development of both a primary market for securities and the post-privatization secondary market.

44. **Notwithstanding these prospects, there are still impediments to the development of the capital market.** Tax reform should equalize the treatment of various forms of capital income to level the playing field among financial assets. Remaining restrictions on foreign investment should be liberalized to remove disincentives to foreign portfolio investment into Slovenia. Since the other comparable, pre-accession countries do not have these restrictions, Slovenia is at a competitive disadvantage in developing its capital markets.

Privatization Investment Funds (PIDs)

45. **The listing of PIDs on the stock market has improved public perception about the transparency of operations in the PIDs**. Disclosure requirements associated with the PIDs' listing on the Ljubljana Stock Exchange have addressed public concerns about governance issues, even though regulation of the PIDs was already tight.[11] Nevertheless, because of the nature of the PIDs' assets, the funds suffer from a lack of clear identity and direction, and their shares are substantially discounted.[12] Market capitalization of the PIDs at end-June 2000 amounted to SIT147 billion (14 percent of total stock market capitalization). This implies a discount of 62 percent on the share value of the PIDs excluding privatization vouchers (74 percent when included).[13] This indicates that the market is on average fully

---

[11] According to the Securities Market Agency, PIDs are very tightly regulated. Every single transaction with an unlisted company must be reported; management companies are required to provide regular reports on their affiliates' activities and use a third party broker when trading on their own account in the Central Securities Clearing Corporation (KDD).

[12] Because of their mixed asset composition—vouchers in socially-owned enterprises and regular equities—and dispersed ownership, the funds are neither mutual funds nor venture capital or holding companies. Hence, a clear investment and management strategy cannot be developed.

[13] The aggregate asset value of the 46 PIDs amounted to SIT556 billion, including unused privatization vouchers of SIT175 billion (or 31 percent). Shares of listed and unlisted companies accounted for 21 percent and 37 percent of PIDs' assets respectively.

discounting the investments in the unlisted shares, and adding a penalty for the closed-end nature of the PIDs and delays in privatization.

46. **A law aiming at transforming privatization investment funds (PIDs) into regular mutual funds will likely make mutual fund investments more attractive.** In 1999, parliament adopted the Law on the First Pension Fund and the Transformation of the Authorized Investment Companies. Under this law, Slovenes could exchange their shares in the PIDs for pension vouchers (held in the new pension fund) and hence reduce the amount of unused vouchers held on the asset side of the PIDs. The government is committed to closing the remaining privatization gap. The PIDs would then be separated into investment companies and common joint stock companies (holding companies) by July 2002. This restructuring would also allow management companies to treat PIDs as regular assets in their portfolio strategy, and focus on improving performance to make PIDs a more attractive investment.

47. **The government, management companies, and market participants all agree that the issue of the remaining privatization gap must be addressed as soon as possible to help restore public confidence in PIDs and, more generally, in capital markets**. To that end, the Ministry of Economic Affairs is leading a working group to propose alternative solutions for dealing with the remaining privatization gap. In addition, work is currently ongoing on drafting a new Investment Companies Law with a view to EU harmonization. There is also consensus on the idea to transform at least part of the portfolio of the PIDs into open-ended funds. However, this transformation must be done carefully: the authorities should ensure adequate liquidity in the capital market and enough disincentives for early divestiture from the PIDs, so that a run out of the funds be avoided.

Insurance

48. **The Slovene insurance industry is small and dominated by one large company.** The industry mobilizes premium income of just under US$1 billion. While the non-life sector is relatively well-developed, the life insurance market is small reflecting an extremely generous social security system; the non-taxation of alternative investment in bank deposits; and a turnover tax on life insurance premiums.[14] The insurance industry is dominated by the former Slovene regional insurer, Triglav, both in life and non-life.

49. **The industry has developed strong financial linkages with the banking sector**. In particular, bank deposits and bonds represent the major investment for insurers—up to half of all investments in some years (total insurance companies' deposits with banks amounted to SIT87 billion at end-1999). Investment policy will change once the new investment rules come into effect in January 2003, when exposures to individual enterprises will be capped and access to EU and OECD capital markets will be permitted (within limits). Another major

[14] This has now been removed for policy durations of more than ten years.

link between banks and insurance arises through credit insurance. After generating financial problems for some smaller insurance companies in the early 1990s, this line of business is now mostly undertaken by the largest insurer.

Pensions

50. **The recent pension reform will maintain the sustainability of the system only for the next few years.** The reform aims at rationalizing the first pension pillar and establishes the legal framework for the development of a voluntary third pillar. These measures stabilize fiscal support to the pension system to about 4 percent of GDP for the next 6-8 years. However, additional measures may be necessary in the medium-term to deal with demographic pressures and the impact of ongoing reductions in employer contribution rate.

51. **As a private pension industry emerges, an adequate regulatory framework should be developed in parallel.** Given the absence of previous market experience with a third pillar in Slovenia, the supervisory authorities should ensure appropriate regulation of pension funds, including tight licensing requirements for new pension funds.

IV. Legal and Supervisory Framework

52. **The framework for prudential supervision of the financial sector in Slovenia has undergone significant reform, with a view to making the applicable laws and regulations adopted following independence, as well as actual supervisory practices, consistent with international best practices and EU Directives.**[15] The new Banking Law and Insurance Act are now to a large extent aligned with that in the EU, and are accompanied by extensive secondary legislation and recommendations aimed at improving the general approach to supervision. Moreover, a new Investment Fund and Management Companies law is planned to (1) introduce a custodian (as required for EU compliance); (2) liberalize investment restrictions of funds, which currently can only invest up to 10 percent in foreign securities; (3) clarify the concept of "related parties"; and (4) transform the Privatization Investment Funds, as discussed elsewhere in this report.

53. **Most of the internationally recognized standards are adhered to, and the level of oversight is generally high**. Part II of this report provides a detailed assessment of compliance with internationally accepted standards: Slovenia complies with 19 of the 25 Basel Core principles; satisfies 25 of the 30 IOSCO principles; and observes 11 of the

[15] The key legal components of this framework are contained in the Law on the BoS (1991) and the Law on Banking (1999). Other relevant financial sector legislation deals with foreign exchange, savings and loan undertakings, money laundering, and financial operations of companies. Sector-specific laws covering the securities, insurance, and pension sectors are discussed elsewhere in this report.

17 IAIS Core Principles. In terms of institutions, both the BoS and the Securities Market Agency are strong and credible regulators, with comprehensive powers and the capacity and willingness to carry out their supervisory mandate. Oversight of insurance and pensions is in transition: a new independent supervisor, with extensive regulatory mandate, has been established under the terms of the Insurance Act.

54. **Notwithstanding this high quality of supervision and compliance with international standards, important gaps need to be addressed, as recognized by the authorities in their Action Plan.** Some of these gaps emanate from the interconnectedness of the financial system. A major supervisory concern relates to the significant exposure of Slovene banks to their shareholders. As the rules and regulations do not provide adequate limitations or conditions, the system could be prone to abusive self-dealing. This could be extremely detrimental if additional capital is needed to underpin the soundness of a bank with a significant exposure to its main shareholder(s). The size of the problem is illustrated by the fact that under a more conservative approach to exposures, e.g., if investments in related parties and exposures to shareholders were to be deducted from capital for regulatory purposes, Tier 1 capital could be significantly reduced. Another concern relates to the current absence of consolidated supervision of banking groups, which could weaken the assessment of soundness and the needed oversight. In particular, without consolidated reporting and supervision there is no certainty that reported capital is indeed as high as stated for the group as a whole. Finally, there is currently a regulatory void on investment guidelines for insurance companies, resulting in asset concentration in banking assets. All these shortcomings have been recognized by the authorities, and the Action Plan includes measures to address them.

55. **Beyond prudential regulations, the legal infrastructure supporting financial intermediation in Slovenia is generally sound.** The accounting and audit professions are governed by the Law on Auditing, the Companies Act, and the Slovene Accounting Standards issued and monitored by the Slovene Institute of Auditors. These standard are consistent with EU and IAS guidelines, although an important difference exists in the historical practice of revaluing assets and liabilities to account for inflation (this rule provides a disincentive to banks to offer non-indexed financial instruments). Bankruptcy proceedings are adequately governed by the Law on Compulsory Settlement, Bankruptcy, and Liquidation that provides three different mechanisms for the resolution of corporate insolvency. With respect to Collateral and Security enforcement, regulations are effective—although there is some concern about court delays in handling of resolution of claims.

56. **Money laundering activities do not appear to be a major problem in Slovenia.** A National Office for the Prevention of Money Laundering was established within the MoF

pursuant to the Law on the Prevention of Money Laundering of 1994.[16] The performance of this Office has been impressive. However, the authorities believe that the regulatory powers of the Office need to be further strengthened, and a new draft Law is currently under discussion in Parliament. The new Law will broaden the range of professions to be included in the list of organizations that may be required to furnish information to include lawyers, auditors, accountants, credit agents, and notaries. It will extend the number of supervisory bodies and provide for differentiated administrative offences (serious, grave and minor). It will also extend the right to freeze specified transactions from two to three days. Slovenia is a fully-participating member of the EGMONT Group, which brings together financial intelligence bodies from some 53-member countries. The proposed legal framework for the prevention of money laundering activities is strong and comprehensive, and the commitment of the authorities to this cause is undoubted.

[16] This Office has wide powers to detect and prevent money laundering. It acts as a link between financial institutions on the one hand and the judiciary and the police on the other hand. It receives, gathers, disseminates, and analyses data obtained from specified institutions, and participates in a variety of training and public relations activities.

SECTION II—OBSERVANCE OF FINANCIAL SYSTEM STANDARDS AND CODES

SUMMARY ASSESSMENTS

I. INTRODUCTION AND SUMMARY

1. This section contains summaries of the reviews of compliance and consistency with key principles and standards applicable to the financial sector. Specifically, it reviews compliance with (a) the Basel Core Principles for Effective Banking Supervision; (b) the Committee on Payment and Settlement Systems' (CPSS) Core Principles for Systemically Important Payment Systems; (d) the International Organization of Securities Commissions' (IOSCO) Objectives and Principles of Securities Regulations; and (e) the International Association of Insurance Supervisors' (IAIS) Supervisory Principles. An assessment of the IMF Code of Good Practices on Transparency in Monetary and Financial Policies was not administered as given Slovenia's outstanding disclosure and transparency practice, it was not deemed to have been a priority in the near term. The detailed assessments for each of the standards and codes formed an integral part of the FSAP and an input into the Financial System Stability Assessment (FSSA).

2. The assessment confirms the very strong supervisory standards attained in Slovenia while noting important regulatory gaps that when addressed would improve oversight and strengthen the financial systems resilience especially in the context of deepening integration in international financial markets. Many of the weaknesses arise from the high degree of inter and intra relations in the financial sector. Supervisory concerns relate to the significant exposure of Slovene banks to their shareholders which opens to the system to the potential dilemma should capital be needed to underpin the soundness of a bank with a significant exposure to its shareholders. Another concern relates to the current absence of consolidated supervision and the regulatory gap governing investment guidelines for Insurance companies.

3. The supervisory authorities are well aware of the concerns raised and have articulated comprehensive plans of action to deal with the specific concerns as well as to ensure even higher levels of compliance with the relevant standards and codes. The relevant actions proposed are summarized under "Authorities Response" listed after each assessment.

II. Basel Core Principles for Effective Banking Supervision

Summary Assessment

General

4. The assessment of the regulatory and supervisory framework for banking was performed in the context of the Financial Sector Assessment Program. The main objectives were to assess the level of compliance with the Basel Core Principles for Effective Banking Supervision, and to suggest areas for further improvement.

5. The legal framework governing banking in Slovenia is provided by the 1999 Banking Act. The Law is supported by a number of decrees issued by the BoS that cover issues of classification of claims, credit and country risks; the harmonization of supervision between banks and savings banks and the introduction of a new deposit guarantee scheme, inter alia. The new Act is harmonized with the European Banking directives except for two principles; the principle of single banking license and the home country control principle, both of which will be implemented as of the date of full accession to the EU. Supervision of the banking system is conducted by the Bank of Slovenia.

6. The detailed assessment was prepared by Marcel Maes (Belgian Banking Commission-retired) and Con Horan (Central Bank of Ireland). The assessment was based on the review of the legal framework and discussions with the supervisory authorities, auditors and commercial banks and benefited from a thorough self-assessment that had been prepared by the BoS. The assessment team befitted from the full cooperation of its counterparts.

Preconditions for effective supervision and macroprudential setting.

7. The necessary preconditions for effective banking supervision are present, reducing the risk exposure of the banks. Notwithstanding, the banking sector in Slovenia is relatively concentrated with 3 banks accounting for approximately 50 percent of banking assets Banks are generally highly profitable, albeit dependent on large margins and asymmetric indexation of contracts. Competition is constrained by the existence of the Bankers Association recommendation on maximum interest rates for deposits. The imminent replacement of the blanket guarantee for deposits by a well designed limited deposit insurance scheme could play a role in restoring a certain degree of market discipline. However, the existence of banks with strong regional roots and market share retail options and small and medium enterprises are often well connected with their local banks which they own in a number of instances.

8. The BoS works to high professional standards and in accordance with the Banking Law (BL), and has developed an enviable reputation. However, in a number of cases the BL will have to be amended to provide a more optimal regime for safe and sound banking and to achieve full compliance with the Basel Core Principles.

9. The institutional environment of the financial intermediaries in Slovenia has been marked recently by the EU Association Agreement and the new banking law that has become aligned to a large extent on that of the EU. This change has been accompanied by an extensive series of secondary legislation and recommendations aimed at improving the general approach to supervision. As noted throughout the assessment, successful implementation of the new rules, regulations and supervisory tools will be a gradual process depending, amongst other things, on the resources of the Banking Supervision Department of the BoS.

10. A major supervisory concern relates to the significant exposure of Slovene banks to their shareholders. As the rules and regulations do not provide adequate limitations or conditions, the case must be made that the financial system contains a very high potential for abusive self-dealing. This could be extremely detrimental if additional capital is needed to underpin the soundness of a bank with a significant exposure to its main shareholder(s). It is recommended that BoS should explore further ways of reducing the levels to which banks are exposed to their shareholders.[17] A connected concern is the more general issue of unsatisfactory corporate governance, arising from this exposure.

11. Another concern relates to the absence of the requirement to obtain supervisory approval of proposed changes that would result in a change in share ownership on a particular threshold. Finally and in the context of the observed inter-relations in the financial sector, a concern is the current absence of consolidated supervision of banking groups. A strong supervision regime must be put in place to supervise this new regime.[18]Table 6 provides the assessment for each Core Principle.

---

[17] It is understood that revised company law legislation is to be considered in early 2001. This would provide an opportunity to address some of the conflict of interest issues which arise between the banks and their shareholders.

[18] It is noted that the decree on consolidated supervision will come into force fully on December 31, 2000.

Main findings—Summary

12. **Objectives, autonomy, powers and resources, CP 1.** Slovenia is compliant with the essential and additional criteria of the six component parts of Core Principle 1. Taken collectively, the central bank and banking laws, regulations, decrees and recommendations provided by the supervisor constitute an appropriate legal framework. While compliant, practical application of the framework will be a learning process and staff capacity should be kept under constant review.

13. **Licensing and structure, CPs 2-5.** Slovenia is compliant with three out of four CPs. The permissible activities and the licensing process are well defined (CP 2 and 3). Equity investments in nonfinancial institutions and real property investments are limited by law, which also prohibits qualified cross-share ownership in banks and other financial institutions. Integration with other banks through equity investments and shared management requires BoS-authorization of the proposed qualified holding. BoS thereby determines whether or not the acquisition of a bank's qualified holding in another bank or a financial institution constitutes an impediment for effective supervision (CP 5). With respect to CP 4 the assessment team has the view that the absence of a required prior approval for significant acquisitions of bank shares constitutes a major supervisory handicap.

14. **Prudential regulations and requirements, CPs 6-15.** Slovenia is materially noncompliant with four out of ten CPs, compliant with three and largely compliant with three. Although BoS has set robust capital requirements for credit risks, it has not to date introduced capital requirements for market risk nor is it currently monitoring capital adequacy on a consolidated basis (CP 6). The conflicts of interest that are not adequately managed by the regulations on connected lending present an even more important problem (CP 7 and 10). Banking regulation in Slovenia explicitly allows banks to grant loans to connected parties, such as shareholders. The banking law also explicitly admits that these credits are extended on conditions that are more favorable than the general conditions. The banking law only requires these credit demands to be decided upon by the board of supervisors of the bank, which means that potential beneficiaries of the credit are in the undesirable position of approving loans to themselves. The fourth materially noncompliant CP concerns the lack of requirements on market risks (CP 12).

15. As to the management information systems that enable identification of portfolio concentrations the BoS should, as a matter of priority, put in place comprehensive procedures for supervising large exposures of banking groups (CP 9). Regarding the risk management processes of banks, the BoS has until now mainly been addressing credit risk. Recommendations on other risks have been circulated but their application has not yet been verified (CP 13). Internal control issues have been adequately dealt with by the BoS. Additional attention should now be given to an internal audit recommendation (CP 14).

Slovenia is compliant with CPs 8, 11 and 15, regarding the adequacy of loan loss provisions, the monitoring and control of country risk and the "know-your-customer" rules.

16. **Methods of ongoing supervision, CPD 16-20.** While BoS did introduce a decree on the supervision of banks on a consolidated basis in December 1999, it will not become operational until the end of December 2000. The regime has to become operational as a matter of priority (CP 20: materially noncompliant). It is necessary that the obligations on management boards to report important developments to BoS should be extended beyond those prescribed in the banking law. The absence of consolidated reporting and analysis is also a significant weakness because the high level of connectedness of the system. This is compensated to some extent by diligent following up on items of concern (CP 18: materially noncompliant). Slovenia is compliant regarding the on-site examinations or the use of external auditors as a means of independent validation of supervisory information (CP 19).

17. **Accounting, CP 21.** Slovenia is compliant with this CP because the legislation and secondary regulations which govern banking accounting represent a valid basis for the supervisory authority. BoS supervisors and external auditors verify the consistency and regularity of the applied accounting policies and procedures as well as the fairness and authenticity of financial statements. Events in the past have lead to the conclusion that synergy with the external auditors should be enhanced and ongoing efforts in that direction should be commended.

18. **Remedial measures, CP 22.** Slovenia is compliant with this CP. The BoS has two types of instruments at its disposal by which it ensures compliance with the rules of safe and sound banking operations. BoS regulatory activities include the adoption of the secondary legislation by which it prescribes a more detailed definition of the method and procedures of their implementation. The other BoS instruments are of a more supervisory nature: BoS performs banking supervision, a part of which is also conducive of supervisory action, ranging from decrees that require remedy of the infringements to decrees that involve the revocation of the bank's operating license.

19. **Cross-border banking, CPs 23-25.** Slovenia, while not yet fully compliant with CP 23, has implemented these CPs to a high degree, due to the new banking law which is calibrated on the EU-Directives. Future supervisory activities in this domain should largely benefit from additional training and experience.

Table 6. Basel Core Principles: Reform Focus and Action Plan

Core Principle	Focus of reform	Authorities response and action plan
Objectives (CP 1)	Staff capacity	(i) Revision of remuneration policy (ii) Program of training intensified
Licensing and Structure (CPs 2-5)	Prior approval of Share acquisition	(i) Revised Rules of Procedure for Licensing Committee (ii) Legislative amendments of Articles 19 and 21 of Banking Act
Prudential regulations and requirements (CPs 6-15)	Connected lending; Large exposures; and market risks	(i) Legislative amendment of articles 80, 82 and 83 of banking act—connected lending and large exposures (ii) Program launched to explicitly recognize market risk but will await new Capital Accord guidance before legislative change
Ongoing Supervision (CPs 16-20)	Consolidated supervision	(i) Implementation of Consolidated supervision; training of Supervisors; and revised reporting schema
Accounting (CP 21)	Strengthen relations with external auditors	(i) Formal framework for cooperation with external auditors
Remedial measures (CP 22)	Fully/largely compliant	Not applicable
Cross Border Supervision (CPs 23-25)	Fully/largely compliant	Proactive approach to formalizing MoUs with foreign supervisory agencies to supplement existing arrangements with Austria and U.S.

Authorities Response

20. The authorities have outlined a time bound action plan with the aim of improving the already high level of compliance with the Basel Core Principles. The Action Plan endorsed by the Governing Board of the Bank of Slovenia gives the mandate to the Banking Supervision Department to target the areas identified by the FSAP mission for improvement. The Action Plan is comprehensive and builds on efforts that have been already underway, e.g., adoption of consolidated supervision and recognition of market risks. While some

elements of the action plan when implemented will ensure fill compliance, other elements are of an ongoing nature. However given the supervisory culture and competence of the supervisory authorities there is every confidence for success.

III. Assessment of IOSCO Objectives and Principles for Securities Regulation

Summary Assessment

General

21. The assessment of Slovenia's securities regulation was performed as part of the FSAP assessment. The main objectives were to assess the levels of observance with the IOSCO Objectives and Principles for Securities regulation and to suggest areas where further development may be appropriate.

22. The assessment was conducted by Melinda Roth, a Senior Financial Sector Specialist, Financial Sector Development Department of the World Bank. The assessment is based on the recently completed Slovene IOSCO self-assessment. In addition, a review of the securities laws, the SMA annual and semi-annual reports and other documents, the Ljubljana Stock Exchange (LJSE) annual report and documents, the annual report from the Central Clearing Corporation (KDD), Slovene market research information from investment banks and other publicly available information was made. Extensive discussions were held with SMA, including the heads of most of the relevant departments. In addition, meetings with market participants, the LJSE, KDD and the MoF also provided input to the assessment.

23. The assessment is based on the Principles of Securities Regulation adopted by IOSCO September 1998. There were no adaptations made for specific country circumstances to the IOSCO Principles, as Slovenia is a full member of IOSCO and has an established regulator. There is no established methodology for the assessment, but the principles themselves contain explanations and specific areas, which should be observed under each principle.

Institutional and Macroprudential setting

24. The SMA was established in 1994 through the implementation of the original Law on Securities Markets. This law was most recently replaced by the new Securities Market Act in July 1999. The new law complies with all European Union Directives. By way of market structure, the LJSE trades stocks, bonds, closed-end investment funds and pension coupons. Currently, the LJSE has 36 members out of whom 12 are banks and the rest are brokerage firms. The LJSE was established in 1989 and trading began in 1990. Since 1995, trading has been conducted electronically with all securities dematerialized.

25. Securities trade on three different organized markets: two official markets (called the A and B markets) and a free market. Total market capitalization excluding investments funds in 1999 was SIT 787.2 billion (approximately US$3.2 billion). This is 22 percent of GDP. Total turnover in 1999 was US$1.1 billion (SIT billion 265.7). Average daily turnover in 2000 has decreased 7 percent from 1999. The number of securities traded on the organized market rose to 263 by midyear 2000 and the number of issuers was 226.

26. Investment services in the securities field include the following: brokerage, managing of individual portfolios, special services (underwriting with or without mandatory buyout of securities, services related to the admission of securities to organized trading) and non-core services (investment advising, keeping accounts of book-entry securities, safekeeping of materialized securities and services related to takeover activities). The investment firm business in Slovenia appears competitive as on average no brokerage seems to account for more than 10 percent of the turnover on the organized market.

Preconditions

27. The preconditions for effective securities supervision are numerous, but perhaps most critical include sound and sustainable macroeconomic policies conducive to investment and savings, enforceable property rights, a supportive political environment free from corruption, well developed infrastructure (such as legal and accounting practices, clearing and settlement systems, payments system) and an effective judicial system. Corporate governance and insolvency mechanisms are also necessary. These appear to be largely in place in Slovenia, with only a few noted exceptions regarding investment and tax regulations.

28. IOSCO also lists several attributes necessary for effective regulation: no unnecessary barriers to entry and exit from markets and products; markets should be open to the widest range of participants who meet specified entry criteria; regulators should consider the impact of requirements when developing policy; and all who make financial commitments or promises must bear an equal regulatory burden. These preconditions appear to be met in Slovenia. The one caveat is that the dominance of the largest banks in capital markets activities does not exclude other participants, but makes it more difficult for others to break into these businesses.

Main findings—Summary

29. The Securities Market Agency (SMA) is a strong regulator with comprehensive powers as well as the capacity and the willingness to carry out their supervisory mandate. Protection of investors and integrity of the market are the objectives behind the securities laws. The SMA has the authority it needs to carry out this objective as well as sufficient independence.

30. Most regulation occurs through licensing as the removal of the license (temporary or permanent) is the only sanction under the SMA's control. The SMA refers all potential criminal cases to the public prosecutor and relies on the Slovene lower courts to administer any penalties imposed by law for civil infractions. This is an enforcement weakness. Each of the financial sector domestic regulators should be able to enforce their own penalties based on administrative violations of their laws and regulations. In addition, domestic financial sector supervisors should have indemnity against any actions arising from the normal discharge of their duties.

31. A new Investment Fund and Management Companies Law is planned with the following proposed changes: (i) the introduction of a custodian (as required for EU compliance); (ii) liberalizing investment restrictions of funds which can only invest up to 10 percent in foreign securities; (iii) clarification of related parties; and (iv) transformation of the Privatization Investment Funds, as discussed elsewhere in this report.

32. The remaining area requiring improvement is disclosure. Acquisition of 5 percent of the shares of a listed company should not take 6 days to become publicly known; such a transaction could easily be immediately disclosed to the public. In addition, any insider buying or selling of a security should also be immediately disclosed. The technologically advanced trading system of the Ljubljana Stock Exchange (LJSE) as well as the LJSE's internet site should be able to accommodate broadcasting such events immediately.

33. Other minor areas require improvement, such as (i) eliminating the discretionary removal of the Director of the SMA; (ii) maintaining a web site and pursuing investor education efforts; (iii) moving toward a system of electronic filing and reporting for all market participants and issuers; (iv) developing regular internet surveillance; (v) allowing SMA staff to buy or sell securities for their personal accounts only after receiving a waiver (instead of reporting the transaction ex post); (vi) allowing foreign funds to offer their shares or units in Slovenia; (vii) relaxing the limitation of 5 percent ownership of a mutual fund; and (viii) increasing the minimum level required to conduct a block trade.

34. An issue for the future as Slovenia enters the EU is how the SMA will regulate outside of Slovenia. The Agreement on Mutual Cooperation among domestic financial regulators is an excellent base to consolidate and strengthen supervision across all financial sectors. In addition, the SMA has recently signed MoUs with Greece and Portugal. Cooperation with regulators in EU Member States will help establish a platform for assistance in cross border issues which are likely to increase. The following Table 7 illustrates the main findings of the IOSCO Assessment:

Table 7. Implementation of IOSCO Objectives and Principles

CP	Principle	Main Findings
1-5	Principles Relating to the Regulator	SMA has broad and comprehensive powers. Enforcement should be strengthened and indemnity for supervisors instituted.
6-7	Principles of Self-Regulation	SROs are modern and efficient.
8-10	Principles for the Enforcement of Securities Regulation	SMA should be able to impose fines directly without referral to the courts.
11-13	Principles for Cooperation in Regulation	Agreement on mutual cooperation for domestic regulators in place.
14-16	Principles for Issuers	Delays in disclosure on acquisition of 5 percent and insider buying and selling should be eliminated.
17-20	Principles for Collective Investment Schemes	Draft and approve new law, compliant with EU Directives, which introduces use of custodian, liberalizes investment restrictions, clarifies related party definition and transforms Privatization Funds. Once this law is passed, these principles will be implemented.
21-24	Principles for Market Intermediaries	Improve financial sector consolidated supervision in order to assess risk of intermediaries; monitor possibility of margin trading.
25-30	Principles for the Secondary Market	In 1999, the LJSE established a new and improved electronic, trading system.

Recommended Plan of Action and Supervisory Response to the Assessment

35. The authorities broadly supported the assessment and have indicated their intention to pursue the recommended action plan Improvements are always necessary given the dynamic structure of the securities markets. One improvement would be the ability for the SMA to impose civil sanctions itself, rather than referring such fines for security violations to the courts. In addition, financial sector regulators should have indemnity in the normal execution of their jobs. These may require major changes in not only the legal framework, and would apply to all of the financial sector regulators. Another action is to draft and pass the new Investment Fund Law, which would introduce the custodian concept to the Slovene market and liberalize foreign investment restrictions. The final major action required is to eliminate delays in disclosure from purchases of 5 percent of the shares of a company and also from insider buying and selling.

36. Several minor areas of improvement are also recommended in the detailed assessment such as (i) eliminate the discretionary removal of the Director of the SMA; (ii) maintain a web site and pursue investor education efforts; (iii) move toward a system of electronic filing and reporting for all market participants and issuers; (iv) develop internet surveillance; (v) allow SMA staff to buy or sell securities for their personal accounts only after receiving a waiver; (vi) allow foreign funds to offer their shares or units in Slovenia; (vii) relax the limitation of 5 percent ownership of a mutual fund; and (viii) increase the level minimum required to conduct a block trade.

IV. Assessment of IAIS Insurance Supervisory Principles

Summary Assessment

General

37. This assessment of the observance of the core principles of the International Association of Insurance Supervisors (IAIS) in Slovenia was undertaken as part of a Financial Sector Assessment Program (FSAP) mission. The main objectives were to assess the levels of observance with the IAIS Supervisory principles, and to suggest areas where further development may be appropriate. Insurance is supervised in Slovenia by the Insurance Supervisory Agency (ISA), a recently formed autonomous entity operating under a Director and reporting to the State Assembly.[19]

38. The assessment was conducted by Rodney Lester, Lead Specialist in the Financial Sector Development Department of the World Bank. Major sources of information used for the assessment included the answers to the questionnaire submitted by the IMF prior to the mission, English language translations of the new Insurance Act and the Ownership Transformation of Insurance Companies Act, the September 2000 Bulletin of Financial Market in Slovenia (MoF), the 2000 Statistical Bulletin of the Slovene Insurance Association, EC Accession Reports and various internal documents provided by the Director of the ISA. In addition extensive interviews were conducted with senior offices of ISA, the Securities Market Agency, members of the actuarial and accounting professions and senior managers of three insurance groups. All those interviewed gave generously of their time and were anxious to be helpful.

39. This assessment has been based on the recently approved Insurance Core Principles Methodology of the International Association of Insurance Supervisors dated October 2000. This contains all the Principles currently being used in FSAPs by the IMF and World Bank, including three new principles (organization, market conduct and cross border cooperation). Slovenia is in the process of installing a new supervisory authority and while regulations are being drafted there were no secondary documents (including manuals) available at the time of the assessment. In consequence it is almost entirely based on the Insurance Act, the questionnaire, discussions with the Director of ISA and the terms of reference for a 'Strengthening of the Slovene Insurance Supervisory Authority' project being supported by the EU. The Insurance Act replaces another statute which was passed relatively recently, and is designed to satisfy the acquis communautaire for entry into the EU. The EU Directives

[19] Prior to the formation of the Agency supervision was the responsibility of a semi autonomous unit in the MoF. The initial staffing of the new entity came from the Ministry unit.

relating to insurance represent minimum requirements, and in fact not all have been implemented in practice in all jurisdictions. However a number of countries have implemented substantially more demanding regimes both through their laws and regulations and through professional standards.

40. Insurance has a wider range of risk factors, including a number of liability-related risks which make supervision more a function of environment and country development than is the case with banking, where more specific and universal core principles have been possible. Thus, in commenting on the consistency of Slovenia's regulatory and supervisory system with the IAIS regime, a certain degree of overriding judgment is required concerning its application in the context of the relatively unique set of circumstances which apply in that country. The Methodology lists essential and supplementary criteria required to meet the core principles. Given the Slovene context this assessment has relied largely on the essential criteria.

Preconditions and macroprudential setting

41. The preconditions for effective insurance supervision are manifold, but perhaps most fundamental of all are enforceable property rights, a supportive political environment and an effective and honest judiciary. These appear to be largely in place in Slovenia, although there is still some reform and negotiation required before the ownership of property is finally settled, and it is unlikely that the judiciary will have been in a position to develop a deep knowledge of the complexities of the insurance sector, a civil code approach notwithstanding. In addition, a macroeconomic climate conducive to the guaranteed nature of many insurance contractual liabilities is essential. High inflation in particular can rapidly degrade an insurance sector (and life insurance in particular, unless indexed, which causes other distortions), while thin and volatile investment markets can make it difficult to design or match desirable liability structures. Slovenia is slowly conquering inflation and is contemplating nominal value accounting. There is a nascent equity market however, the domestic corporate and sub sovereign debt markets are practically non-existent and the government bond market is shallow.

The insurance product is often prone to poor information flows and is particularly subject to moral hazard and information asymmetry. Slovenia has recently passed a modern insurance law, has a strong accounting profession and, with the support of Phare and the British Government Actuary's Office in particular is also establishing the basis for an effective actuarial profession. The new insurance law is very advanced in providing a set of supervisory tools, including a range of responses and sanctions in the event of poor or dishonest practice or insurer distress, although it gives the supervisor powers of authorization and intervention which could be described as being unusually wide.

42. The supervisor must have the resources, preferably funded from sources other than general government revenues, to carry out his or her job. A risk based approach based on efficient and timely information and effective interpretation thereof can reduce manpower needs, however there is no substitute for on site inspections and sufficient human capital must be made available. These are manifestly not in place at present, especially given the additional pressures of the current transition period (for example writing and promulgating regulations and operating manuals). We understand that a vigorous recruitment effort is underway and this assessment is predicated on the assumption that sufficient manpower will be in place within the next six months.

Main findings—summary assessment

43. Slovene insurance and pension regulation and supervision is in transition. Under the previous legislation the supervisor was part of the Ministry of Finance (MoF). However a new autonomous supervisor has been established under the terms of the Insurance Act, which was promulgated on January 2000. Given the extensive powers of the new supervisor to issue regulations the new entity also has a significant regulatory role. The supervisor is required to deliver all the necessary regulation, amounting to 22 documents, by the end of December.

44. The supervisor was initially staffed almost entirely by the team from the MoF and as at mid November 2000 there has been little recruitment. The new Insurance Supervisory Agency (ISA) is adequately funded by levies on the insurance sector. Recruitment effort is underway to increase the staffing from 7 people (2 of whom are absent) against a projected immediate establishment of 18. The supervisor is receiving technical support from Price Waterhouse Coopers under the sponsorship of the EU in order to facilitate the transformation necessary for accession to the EU.

45. The new Insurance Act is based largely on the current set of EU Directives affecting insurance. These represent a base set of requirements to satisfy the needs of a diverse set of nations and are due for extensive upgrading in the next three years, particularly under a number of headings relevant to prudential (risk) management. A number of EU jurisdictions have in fact substantially strengthened the Directives for domestic purposes, through law, regulations and professional standards. The EU directives do not meet all the necessary criteria established by the IAIS to back up the 17 Core Principles.

46. This assessment of the Slovene observance of the Core Principles assumes that staffing levels will be rapidly increased and backed up by effective training and the development of at least licensing and on site inspection manuals. It also relies to a large extent on the terms of reference underlying the insurance supervisory technical support being given to Slovenia. Table 8 below provides a summary of the assessment.

Table 8. Observance of IAIS Insurance Supervisory Principles

CP		Comments and Corrective Actions
1	Organization	
2	Licensing	There is a potentially unsatisfactory situation in that while life and non life insurance must be in separate vehicles for new insurers, all existing insurers have been indefinitely grand fathered. For existing insurers, assets covering life mathematical reserves are quarantined, however not those covering the capital underpinning the life business.
3	Changes in Control	
4	Corporate Governance	The corporate governance principle would have full observance status if the supervisor could require insurer directors to have complaints procedures in place.
5	Internal Controls	Again the main deficiency is the inability to enforce market conduct rules.
6	Prudential—Assets	This is a key principle and it is a serious matter that Slovenia has received a materially non-observed. The main reasons for this assessment are the lack of reference to credit risk, the non-applicability of investment guidelines to minimum capital and ambiguity regarding the supervisor's powers in this area under the transition conditions. In the case of the last item the ideal would be to see mutually agreed transition arrangements being put in place for investment policy. However we have been advised by the supervisor that legal backing is essential if a satisfactory investment regime is to be established.
7	Prudential—Liabilities	
8	Capital Adequacy and Solvency	
9	Derivatives and off balance sheet items	There is no reference to derivatives in the new law and we gained the impression that this risk has not been fully recognized by the supervisor, although contingent liabilities are discussed in the new post graduate actuarial course at Ljubljana University.
10	Reinsurance	
11	Market Conduct	Market conduct is essentially not covered under the new Act. This will become an important topic as most of the new third pillar pensions are likely to be underwritten by insurers.
12	Financial reporting	
13	On site inspection – access to information	
14	Sanctions	
15	Cross border business operations	
16	Cooperation	
17	Confidentiality	

V. Assessment of Core Principles for Systemically Important Payments Systems

Summary Assessment

General

47. The assessment of the payment and settlement system in Slovenia was performed in the context of the FSAP. The main objectives were to assess the level of compliance with the Core Principles for Systemically Important Payments Systems, and to suggest arrears for further improvement.

48. The present assessment was conducted by Karsten Biltoft (Danmarks National Bank) on the basis of work in the field and available documentation, including the European Central Bank's Blue Book on payment systems in countries that have applied for membership of the European Union.

Institutional and Macroprudential setting

49. The payment system infrastructure in Slovenia has in recent years undergone important changes aimed at reducing risks and increasing efficiency. However, the system is still in a process of transition. Most importantly, the key functions performed by the Agency for Payments of the Republic of Slovenia (hereinafter the Agency) are being phased out. According to the draft Law on Payment Services (first reading), the Agency shall complete all activities within the framework of payment transactions and shall wind up provision of payment services as of June 30, 2002. The migration of payment services from the Agency to the financial sector is performed after mutual agreement between the MoF and the BoS.

50. In April 1998, the BoS introduced a modern Real Time Gross Settlement (RTGS) system for large and/or urgent payments. And in October 1998, the BoS introduced a netting system for small value non-urgent payments, the Giro Clearing System. Until the migration is over, the Agency will continue to perform payment services for legal entities. As of June 2000, a process of consolidation between, on the one hand, the RTGS system and the Giro Clearing and, on the one hand, the Agency has been completed. Consequently, payments in all directions between participants (banks, savings banks, the Agency and the BoS) may be conducted in both the RTGS system and in the Giro Clearing. In order to improve liquidity management, the BoS operates an information system, which gives participants relatively recent information on the status of relevant accounts and positions. At the same time, the BoS continuously monitors the consolidated balance on the settlement account and the

positions with the Agency of banks and savings banks. In case of a consolidated overdraft, the institution in question is alerted and asked to supply additional funds.

51. To some extent, the retail payment system remains fragmented, and there is no national Automated Clearing House in Slovenia. When the Giro Clearing System was introduced in October1998, it was considered to be a first step towards a new Integrated Small-Value Payment System (ISVPS). Discussions continue between the authorities and the private sector participants on the future ISPVS, including the organisational and decision-making structures. In this respect, it is envisaged to establish a Payment Systems Council, which could also deal with broader issues regarding payment systems.

52. On the securities market, the KDD (Central Securities Clearing Corporation) performs a number of functions, including clearing and settlement of transactions on the Ljubljana Stock Exchange (LSE), a central registry of dematerialised securities and a central depository. At present, the cash leg of securities transactions is settled through accounts with the Agency. This procedure implies a risk of contagion from the Agency to the KDD, as the payments made by brokers is only final at the end of the day. However, as part of the ongoing reform, the settlement accounts will move to the BoS. Along with facilities for Delivery versus Payment for off-market transactions, this move is expected to take place in mid 2001.

Main Findings—summary assessment

53. In light of the facts that the role of the Agency for payments in the payment system is being phased out, and that the consolidation of retail payment systems has yet to materialise, this assessment of observance of the Committee on Payment and Settlement Systems (CPSS) core principles for systemically important payment systems is performed on the RTGS and the Giro Clearing systems of the BoS. However, some risks associated with the interaction of the different systems during the period of transition are identified and noted. The assessment takes as a precondition that the Agency role will indeed be phased out in the near future. Furthermore, an assessment of integrated small-value system should be performed when such a system materialises.

54. According to the draft law on Payment Services, the Agency for Payments shall wind up provision of payment services as of June 2002. The BoS is responsible is for overseeing payment systems. The legal basis for this oversight function may be found in the Law on the BoS. In the new draft Law on Payment Services, the task of supervision for oversight of payment systems is more clearly spelled out and designated to the BoS. In the Annual Report of the BoS, there is a separate section on important developments in payment systems. Apart from the special section in the Annual Report, officials of the BoS take

various opportunities to inform on issues relevant to payment systems, for example in articles. Decrees by the Central Bank on the payment systems are published in the Official Gazette of the Republic of Slovenia.

55. Other than the Agency for Payments, which is having its present key role in provision of payment services for legal entities phased out, the BoS operate the two most important payment systems in Slovenia. In April 1998, the BoS introduced a modern Real Time Gross Settlement (RTGS) system for large and/or urgent payments. And in October 1998, the BoS introduced a netting system for small value non-urgent payments, the Giro Clearing System.

56. In order to improve liquidity management in the period of co-existence between the old and the new systems, the BoS operates an information system, which gives participants relatively recent information on the status of relevant accounts and positions. At the same time, the BoS continuously monitors the consolidated balance on the settlement account and the positions with the Agency of banks and savings banks. In case of a consolidated overdraft, the institution in question is alerted and asked to supply additional funds. Various departments of the BoS are working together in order to secure that banks are prepared for taking over the handling of domestic payments for legal entities.

57. To some extent, the retail payment system remains fragmented, and there is no national Automated clearinghouse in Slovenia. Discussions continue between the authorities and the private sector participants on the future new Integrated Small-Value Payment System (ISVPS), including the organisational and decision-making structures. In this respect, it is envisaged to establish a Payment Systems Council, which could also deal with broader issues regarding payment systems.

58. The payment systems are broadly robust but the risks associated with the migration process need to be closely monitored. Adoption of the draft Law on Payment Services will further strengthen the legal basis of payment systems. The present problems for banks in respect to managing credit and liquidity risks ought to be over when the migration is complete. The systems are generally very secure and contingency measures are in place. Areas of attention could be a second site for the systems to run on in case of disruptions on the primary site and more regular full testing. In spite of the relatively high reserve requirements serving as a buffer in the Giro Clearing System, which was intended to be a pilot project, it may be considered to take measures to further ensure timely daily settlement. Table 9 provides an overview of the assessment against the CPSS Core Principles.

Authorities Response

The authorities broadly agreed with the assessment and articulated a work program to address noted weaknesses. The program is comprehensive and well considered and should serve to improve the already high standards achieved in this area.

Table 9. Compliance with the CPSS Core Principles for Systemically Important Payment Systems

Core Principle	Reform focus	Action plan
1. The system should have a well-founded legal basis under all relevant jurisdictions.	It is assumed that the draft Law on Payment Services will be adopted without material changes to the relevant provisions	BoS to stay involved to ensure passage of Law
2. The system's rules and procedures should enable participants to have a clear understanding of the system's impact on each of the financial risks they incur through participation in it.	Fully/largely compliant	Not applicable
3. The system should have clearly defined procedures for the management of credit and liquidity risks, which specify the respective responsibilities of the system operator and the participants and which provide appropriate incentives to manage and contain those risks.	Once the ongoing migration is completed, the payment systems ought to be in a position to comply	Not applicable
4. The system should provide prompt final settlement on the day of value, preferably during the day and at a minimum the end of day.	Fully/largely compliant	Close monitoring of Giro system to decide on optimal settlement cycles
5. A system in which multilateral netting takes place should, as a minimum, be capable of ensuring the timely completion of daily settlement in the event of an inability to settle by the participant with the largest single settlement obligation.	The high reserve requirements provide a buffer in the system	Full security scheme to be defined and implemented
6. Assets used for settlement should preferably be a claim on the central bank; where other assets are used, they should carry little or no credit risk and little or no liquidity risk.	Fully/largely compliant	Not applicable
7. The system should ensure a high degree of security and operation reliability and should have contingency arrangements for timely completion of daily processing.	Focus areas could be to take a second site in operation and to perform regular full testing	(i) Adoption of remote stand-by center for emergencies (ii) New interbank money market arrangement introduced (iii) Revision of banks contingency arrangements
8. The system should provide a means of making payments which is practical for its users and efficient for the economy.	Fully/largely compliant	Formalization of cooperation agreement between banks and the BoS
9. The system should have objective and publicly disclosed criteria for participation, which permit fair and open access.	Fully/largely compliant	Not applicable
10. The system's governance arrangements should be effective, accountable and transparent.	Fully/largely compliant	Ongoing work of Payments Council