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Slovenia: the Eurozone's next bailout?

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Summary

Without attracting much wider attention, Slovenia has spent the last six months struggling to avoid following Cyprus into a Eurozone bailout. In particular, Ljubljana has been fighting a rear-guard action with its chronically damaged banking system. The numbers – including downgraded growth forecasts this week - increasingly suggest this is a fight it will struggle to win. A bailout would be a political and policy setback for Ljubljana, but would it have any wider consequences for the Eurozone? Slovenia may be an extreme example, but it is a reminder that the legacy problem of weak banks is still lingering under the first signs of good economic news for the Eurozone.

In the IMF forecasts for the EU released in the middle of October there are only two EU states that are now forecast *not* to grow in 2014: Cyprus and Slovenia. Cyprus imploded in mid-2012 under the weight of its huge and fatally crippled banking system and was bailed out by the EU and the IMF in March 2013. Without attracting much wider attention, Slovenia has spent the last six months struggling to avoid the same denouement. In particular Ljubljana has been fighting a rear-guard action with its chronically damaged and quarter-state owned banking system.

Downgraded growth forecasts for 2014 last week suggest that Ljubljana may be on the verge of losing the struggle. The results of bank audits expected next month will quantify the hole in balance sheet of the Slovenian banking system, and are widely expected to outstrip the provisions Ljubljana has made. Given the underlying dynamics, Slovenia would be hard-pressed to avoid requesting an international bailout. This would be a political and policy setback for Ljubljana: would it have any wider consequences for the Eurozone?

Bad banks

Ljubljana has been at pains over the last year to stress the differences with Cyprus. The Slovenian state has a debt to GDP ratio of just over 50%, compared to more than 85% in Cyprus on the eve of its bailout. The Cypriot banking system was seven times the size of the Cypriot economy while Slovenia's is 136%.

But Slovenia's banks are still sick enough to be exerting a potentially crippling drag. Large amounts of cheap ECB LTRO funding since early 2012 has improved their liquidity. It has not however compensated for higher wholesale funding costs and the fall in interest income from falling lending, high levels of bad debt and a huge bottleneck in bankruptcies. When the Bank of Slovenia surveyed the market in June 2013, almost a fifth of all loans by Slovenia's large majority state-owned banks were non-performing, and over two thirds of all loans to construction firms.

Three years of bank losses have provided little capital for re-investment in bank capital bases. Capital adequacy requirements are instead being met by shrinking lending and buying back junior debt (see Table 1). Despite restructuring plans and an initial recapitalisation, in the first half of 2013, majority state-owned NLB, which accounts for a quarter of the whole Slovenian banking system, contracted its lending by a further 3% (it has shrunk by almost 20% since 2010) and made a further net loss of €86mn, further eating into its core regulatory capital. The

portion of loans by the wider NLB Group that were non-performing in June 2013 was 31.1%.

In September the European Commission quietly signed off on guarantees for depositors and senior creditors for Faktor and Probanka, two small private universal banks that account for less than 5% of the assets in the Slovenian banking system. A week later, the Slovenian Central Bank liquidated both banks, calculating that two months of speculation over the fate of both banks posed a greater risk of deposit flight and contagion than a quick and decisive euthanizing. Assets from both will be transferred into a bad bank. The Slovenian state has guaranteed around €1bn in liabilities in the two institutions, including senior creditors and deposits beyond the €100,000 level common across the EU and stipulated by the Slovenian Central Bank.

Total Assets 03.13	€46.11bn
Balance Sheet shrinkage since 2011	-6.4%
ECB liquidity 03.13 as a percentage of total funding (change since 2011)	8.6% (+145%)
Net change interest income 2011-2012	-12.9
Net profit 2012 (2011)	-€748mn (-€442mn)
Non-performing loans, % all assets 03.13	14.60%

Table 1: Slovenian banking sector key indicators 03.13
Source: Bank of Slovenia Financial Stability Report

The use of blanket deposit guarantees for such small, unlisted, private banks – with Brussels' explicit approval – was a sign of the depth of concern at the systemic weakness of the Slovenian banking sector, especially the large state-owned banks that make up the core of the sector and are its weakest link. The European Commission ordered an independent audit of the capital hole in the Slovenian banking system in May – it is expected to report next month.

Difficult politics, worse numbers

So the next few weeks are likely to bring these problems to an inflection point. Prime Minister Alenka Bratusek must steer an austerity budget through Parliament in November, which Bratusek has labelled a vote of confidence in the coalition government. Her Positive Slovenia party delayed its annual congress last week to prevent a challenge to her leadership from Ljubljana mayor Zoran Jankovic, who resigned from the role in February. Losing this vote would almost certainly tip market scepticism on Slovenia over the edge. But because the budget itself is subject to coalition horsetrading before it reaches the floor of the Parliament, Bratusek is likely to win her vote of confidence.

The bigger problem is not politics but numbers. The Slovenian central bank unveiled its Autumn forecasts on October 9, downgrading its growth expectations from -1.9% to -2.6% for 2013 and projecting a contraction of 0.7% for 2014. Ljubljana is already running a deficit of 3.7% and Slovenian 10 year yields have not fallen below 6% since June 2013, which means that a small change in sentiment, or even general uplift from a rise in bunds could push Ljubljana into the kind of territory that markets regard as unsustainable. Moody's already has Slovenia at junk status. Downgrades from S+P and Fitch would further raise borrowing costs and could ultimately damage the scope for Slovenian banks to borrow against sovereign debt with the ECB, which is all that is keeping them liquid at a bearable cost (Table 1).

The results of the bank audits and stress tests in late November will put the problem into further stark relief. Most analysts expect the stress test to identify a capital hole of between €2-5bn. Ljubljana has set aside €1.2bn to cover recapitalisations. It has also maintained cash balances of between €3 and 4bn in 2013 – boosted by a big package of five and ten year funding in May 2013. But this could be badly stretched by a large recapitalisation and will also have to bear the estimated €400bn cost of the Probanka and Faktor guarantees, albeit over three years.

This would leave Slovenia thinly funded going into 2014, with a €1.5bn five year bond expiring in April and growth and revenue prospects deteriorating both for banks and the state. Finance Minister Uros Cufer has suggested that Slovenia could seek market refinancing before the end of the year to cover this. But interior Minister Gregor Virant implied to the STA news agency last week that an ESM loan would be

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cheaper and more sustainable. Bratusek herself has used a similar formula with respect to seeking the cheapest option. Barring an unexpectedly optimistic stress test, the odds on this happening now look pretty short.

Does this matter? Slovenia is small and its cashflow problems are relatively small as a proportion of the resources of the Eurozone or even the limited resources of the European Stability Mechanism (ESM). A combination of ECB emergency liquidity assistance for Slovenia's banks and ESM funds to support recapitalisation and backstop deposit guarantees would be comparatively small in quantum. Slovenia's overall debt profile positions it a lot better for taking on ESM liabilities than previous bailout recipients.

If it does happen, the Cypriot experience suggests that ECB liquidity guarantees are capable of containing any wider crisis of confidence on run on banks. But for bank equity holders and creditors Slovenia, like Cyprus, would also presumably involve another opportunity for Brussels, and Berlin (and the IMF – if it was involved, which cannot be taken completely for granted) to signal a new rigour the wiping out of bank equity (and a quarter of the equity in the Slovenian banking system is owned by the state itself) and bailing in subordinated debt. As with the European Commission's recent showdown with Rome over the conditions of any recapitalisation of Monte dei Paschi di Sienna, recapitalised Slovenian banks can expect an intrusive and robust price to be exacted.

Support to Slovenia would certainly be a lot less politically difficult in Brussels than it was for Cyprus, where the large scale of Russian offshore deposits made a bailout intensely politically sensitive. But even small amounts would be politically sensitive in Northern Europe – where the Netherlands is struggling with an austerity budget and Germany has just seen an election campaign in which the current government said it foresaw no further Eurozone bailouts.

But at the highest level, a sixth bailout would provide a sharp counterpoint to a developing upbeat political narrative about the Eurozone's ability to break free of the gravity of its banking crisis. Brussels would no doubt suggest that Slovenia is the last part of a legacy problem. But it also points forward to the big problem in 2014, which is the first serious stress testing of Eurozone banks by the ECB and a clearer picture of how badly European sovereigns and bank creditors may still be exposed to over-extended banks kept alive by cheap liquidity and the flickering hope of growth in 2014.

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