The Limits of Counter-cyclical Bank Regulation: Managing the Credit Booms in Central and Eastern Europe after EU Accession

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Abstract: The extent to which banking sector regulators should employ counter-cyclical measures has emerged as an important debate in the aftermath of the 2008 global financial crisis. Yet, is counter-cyclical banking regulation compatible with a supranational framework of banking supervision in the European Union (EU)? The protracted negotiations of CRD IV and CRR, implementing Basel III in the European Union, have highlighted the divergence in regulatory preferences among the EU’s member states about the optimal level of harmonizing banking sector regulation. Using a comparative design, this paper investigates the range of counter-cyclical policy tools such as increasing the risk weights of mortgage loans on banks’ balance sheets, capping the share of foreign currency loans in banks’ portfolios, and requiring higher capital adequacy ratios than internationally agreed levels used in Bulgaria, Estonia, Hungary, and Slovenia during the short-lived credit booms in these countries after they joined the European Union. The paper also examines whether new EU member states that are proponents of counter-cyclical regulatory tools are more hesitant to give up national discretions in order to achieve a more coherent European banking supervision framework.
Section I: Introduction

Following the 2008 global financial crisis, counter-cyclical regulatory measures have been discussed as an important supplement to the micro-prudential approach which prevailed before the crisis. In the European Union, the Capital Requirements Regulation (CRR) and latest revision of the Capital Requirements Directive (CRD IV), implementing Basel III, introduce counter-cyclical regulatory measures such as requiring banks to hold more capital and provisions, putting limits on leverage, and requiring more stringent liquidity requirements (Griffith-Jones et al. 2009; Howarth and Quaglia 2013; Moschella and Tsingou 2013). Yet, is counter-cyclical banking regulation compatible with a supranational framework of banking supervision in the European Union (EU)? The protracted negotiations of CRD IV and CRR have highlighted the divergence in regulatory preferences among the EU’s member states about the optimal level of harmonization in banking supervision.

Eight Central and Eastern European countries joined the EU in 2004 and Bulgaria and Romania – in 2007 (Jacoby 2004; Vachudova 2005; Epstein 2008). During the period 2000-2007, the region was the fastest growing in the Union (Lamine 2008; Bohle 2013; Myant et al. 2013; Jacoby 2014). The economic boom was most visible in states that were well on track to join the EU such as Estonia, Hungary, and Slovenia (Bohle 2013; Epstein 2014; Epstein and Jacoby 2014). As their banking systems channeled foreign capital into the economy, more resources became available for consumer and business loans. Driven by high demand for new housing and office space, prices in the real estate sector grew exponentially. In several countries such as Bulgaria and Estonia, bank supervisors used counter-cyclical measures in an attempt to cool off the credit booms. The measures employed in the region in the mid-2000s capture the broad spectrum of counter-cyclical regulatory tools introduced by Basel III and, subsequently, CRD IV and CRR. Even though the credit booms in Central and Eastern Europe preceded the global financial crisis, examining bank supervisors’ responses helps us gauge the impact of counter-cyclical regulation and the limits of this approach.

In this paper, I focus on four countries which implemented counter-cyclical measures to varying degrees: Bulgaria, Estonia, Hungary, and Slovenia. The Bulgarian Central Bank has applied consistently a risk-averse approach and has intervened with counter-cyclical measures such as requiring higher provisions against bad loans and putting in place mandatory limits on the rate of credit expansion. In Estonia too, the Central Bank has used a risk-averse supervisory approach since the beginning of transition despite the overall free-market orientation of Estonian governments. In the Hungarian case, until 2007, the supervisory approach was predominantly market-based and relied on improved information provision about financial risks to banks and customers. In Slovenia, the Central Bank took measures to build higher provisions during the period of rapid credit expansion and closely monitored liquidity.

The paper probes the effectiveness of counter-cyclical regulatory tools at the national level and concludes that they can be circumvented by both banks and governments, which disagree with bank supervisors’ policy. The analysis shows that counter-cyclical regulatory measures can only mitigate risks in the short-term. The Hungarian case demonstrates that if a government wants to encourage economic growth and has political channels to steer supervisory policy, it can easily counteract any measures intended to cool off credit booms. Furthermore, the Bulgarian case highlights that if the foreign-owned banks prefer to circumvent the more stringent domestic criteria for issuing new loans, they can fall back on the parent banks to do so, while nominally complying with the domestic legal framework. Banking sector stability is also inextricably linked with the performance of the real sector. During a protracted
economic downturn, the growing percentage of non-performing loans clogs up banks’ balance sheets. Bank supervisors can make a difference in the margins, for example, by requiring higher provisions against bad loans during periods of economic stability. However, they can do very little to prevent impending bank defaults when the banks are already weakly capitalized. In those circumstances, governments step in to recapitalize the banks, as in the Slovenian case, or the foreign-owned banks recapitalize their subsidiaries, as in Estonia.

What are the implications of the analysis for the European bank supervisory regime developed since 2008? First, this paper shows that pursuing a more active domestic management of the banking system through counter-cyclical tools does not immediately guarantee greater financial stability. Sections II-VI examine the regional response to credit booms in the mid-2000s. Second, my analysis suggests that the EU’s new member states from Central and Eastern Europe advocated preserving more national discretions during the negotiations of the EU’s single rulebook regime. Section VII shows that during these negotiations, the new EU member states were among the strongest proponents of preserving some national discretions that would allow domestic bank supervisors to pursue stricter policies than the commonly agreed European ones. Section VIII summarizes the main findings of the paper.

Section II: Regional responses to rapid credit expansion in Central and Eastern Europe

The four countries examined here implemented different national regulatory responses to the credit booms in the 2000s. Among the four states, Estonia has weathered the global financial crisis relatively well. The Bulgarian banking system has remained well-capitalized by regional standards, but the real sector has stalled and the percentage of non-performing loans has increased sharply. In both countries, the leading banking sector regulator is a department in the Central Bank which takes a more risk-averse regulatory approach. In Estonia, the Financial Supervision Authority is responsible for the technical aspects of supervision such as carrying out inspections.

By contrast, the impact of the global financial crisis and economic downturn has been more severe in Hungary and Slovenia. Hungary was among the first countries in the region to experience balance of payments problems. It resorted to borrowing from the IMF under a Stand-by Agreement, which was active 2008-2010. Slovenia has been affected negatively by the quick reversal of cheap credit from the international capital markets after 2008. Since 2010, the government has repeatedly provided capital injections to the domestic banking sector in an effort to stabilize it. The main banking sector regulator in Hungary is the independent Financial Supervisory Authority (HFSA) and in Slovenia – the Central Bank. Both regulators were engaged in close and extensive monitoring of the domestic banking sector, but as we will see in the case studies below, they were cautious about taking hands-on measures to cool off the growing credit bubbles.

The graphs below show several important indicators of banking sector stability and efficiency in the four countries. Figure 1 presents the capital adequacy ratios, an indicator of how well-capitalized a country’s banking system is, since 1997. Figures 2 and 3 display the return on equity rate (RoE) and return on assets rate (RoA), which gauge banking sector efficiency. Lastly, Figure 4 presents the dynamics of non-performing loans as percentage of total loans in the four countries. Bulgarian bank regulators were the most risk-averse among the four countries after the Asian financial crisis in 1997-1998. During the ‘good times’ of
sustained economic growth in the region, 2003-2007, we do not observe much differentiation in the capital adequacy and efficiency of the banking systems.

After the 2008 global financial crisis, the Bulgarian and Estonian banking systems, which have the two more risk-averse domestic regulators in my case selection, have been better capitalized than the Hungarian and Slovenian ones. At the same time, as we can see on Figure 4, the percentage non-performing loans has increased considerably in Bulgaria, Hungary, and Slovenia. This has become a major concern for banking sector stability. Only in Estonia, the percentage of non-performing loans has stabilized around 4 per cent. In addition to the risk profile of the domestic regulators, the cooperative attitude and capital injections by Nordic banks into their Estonian branches and subsidiaries have been very important for maintaining banking sector stability in the country after 2008.

**Figure 1:** Capital adequacy ratios, 1997-2012

Figure 2: Return on equity (RoE), 1997-2012


Figure 3: Return on assets (RoA), 1997-2012

Figure 4: Non-performing loans as percentage of total loans, 2008-2012

Drawing on a typology of policy options to control rapid credit growth by Hilbers et al. (2005), Geršl and Jašová (2012) have conducted a survey of central bankers in the region to determine which supervisory measures were used. As summarized in Table 1, the authors considered several categories of policy responses such as macroeconomic policy measures, prudential measures, supervisory monitoring tools, market instruments, administrative measures, and promotion of better understanding of risks. They found that bank supervisors in the region implemented 82 policy interventions in total in an attempt to curb the credit booms in the mid-2000s. Geršl and Jašová (2012) highlighted that countries using a fixed exchange rate regime such as Bulgaria and Estonia tended to be more risk-averse and implemented more measures to control credit growth. Among the four states in my analysis, Bulgaria put in place the most measures designed to curb credit growth and Slovenia – the fewest. The case studies presented below explain in greater detail the supervisory measures adopted in the four countries.

Table 1: Policy measures against rapid credit growth implemented in the four countries, 2003-2008

<table>
<thead>
<tr>
<th>Policy measure</th>
<th>Bulgaria</th>
<th>Estonia</th>
<th>Hungary</th>
<th>Slovenia</th>
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<tbody>
<tr>
<td>Interest rate response</td>
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<td>Reserve requirements</td>
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<td>- Changes in the required level</td>
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<td>- Differentiated by currency</td>
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<td>- Differentiated by deposit type</td>
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<td>- Broaden the reserve base</td>
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<td>Higher capital requirements or higher risk weights</td>
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<td>Liquid asset requirements</td>
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<td>Tighter asset classification rules</td>
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<td>Tighter provisioning rules</td>
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<td>Tighter eligibility criteria for certain loans</td>
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<td>- Limit on LTV</td>
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<td>- Limit on LTI/payment to income</td>
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<td>Tighter rules on valuation criteria</td>
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<td>Measures targeting FX borrowing</td>
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<td>- Targeting unhedged borrowers</td>
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<td>- Tighter net open position limits</td>
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<td>Soft measures, i.e. guidelines</td>
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<td>Tighter supervision</td>
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<td>Capital controls</td>
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<td>Credit ceilings</td>
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<td>Taxes on real estate transactions</td>
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Source: Geršl and Jašová (2012)
Section III: Bulgaria

The main banking sector regulator in Bulgaria, the Bulgarian National Bank (BNB), has special legal powers to issue ordinances, which has enabled the BNB to implement counter-cyclical measures during the credit boom relatively quickly and in spite of the government’s reluctance. These legal instruments, issued by the BNB’s Governing Council, are binding for market participants, but do not need to be endorsed by the government in power or parliament. Most ordinances contain technical standards and guidelines about applying international rules and best practices in the context of the Bulgarian banking system.

Roumen Simeonov, Head of the BNB’s Banking Supervision Department, has expressed general support for the rationale of counter-cyclical policy and has advocated its use in Bulgaria. In his view, to achieve financial stability, supervisory policy should be less restrictive during recessions to speed up recovery, but more conservative during booms when banks are lending very aggressively (Personal interview, Simeonov 2012).

In the early 2000s, Bulgaria’s banking system experienced an influx of foreign capital. The branches and subsidiaries of large foreign banks such as UniCredit, Raiffeisen, and Société Générale increased their lending to private individuals and businesses. In response, the BNB intervened proactively to slow down credit growth and promote more cautious risk management. According to Simeonov, the boom was a concern for bank supervisors and they introduced a series of measures such as increasing the risk weights of the types of loans they deemed most risky, increasing the required provisions for non-performing loans, and raising the required minimum capital reserves (Personal interview, Simeonov 2012). He pointed out that Austrian and Greek banks tended to take riskier lending decisions during the credit boom period.

The Bulgarian National Bank was stricter in enforcing compliance with the regulatory framework after the 1997-1998 domestic banking crisis, which was partly induced by the Asian financial crisis but also by domestic mismanagement and crony capitalism (Ganev 2007; Spendžharova 2008; Vachudova 2009). In 2004, the Central Bank adopted stricter rules for classifying assets and determining banks’ capital adequacy. For example, starting in October 2004, only 50 per cent of the cash in banks’ vaults was recognized as a reserve asset, instead of 100 per cent, as was previously the case. The BNB also abolished the minimum threshold of 10,000 Bulgarian leva for disclosing loans to the central credit registry. This move created an incentive for banks to provide more information about their lending to the central credit registry (BNB 2004: 12). The risk-averse regulatory approach was maintained in 2005-2006. The Central Bank took measures to keep a high level of liquidity in the banking system. It imposed supplementary reserve requirements for particular banks, which were more risk-seeking and could create instability in the domestic banking system (BNB 2007: 33-34).

However, the banks were keen to maintain or increase their market share (IMF 2007: 56). Furthermore, Bulgaria continued to maintain an open capital account and a liberal economy, which enabled banks to borrow abroad or set up affiliated non-bank financial companies that were not subject to the credit limits. Anticipating these responses, the BNB stepped up its data collection operations and monitored closely both developments in the banking sector and the impact on the country’s macro-economic framework. In particular, the BNB monitored developments in the leasing sector and also required banks to provide data to the central credit registry on loans that they had sold to other financial institutions (IMF 2007).
According to the European Bank for Reconstruction and Development (EBRD), Bulgaria implemented the highest minimum capital adequacy ratio of all new EU member states throughout the credit boom (EBRD 2012). Despite the range of risk-averse supervisory measures, the annual rate of credit growth in the country remained close to 50 per cent in 2004. The measures taken in the early years of the boom such as increasing reserve requirements and withdrawing public deposits from the banks seemed to be insufficient to cool off the rapid credit growth. As a next step, bank supervisors implemented more direct administrative measures. In early 2005, the BNB attempted to reduce the rate of credit expansion in the banking sector to 30 per cent. Banks were allowed to expand credit by 6 percent per quarter, taking the end of March 2005 as the base period (EBRD 2012). Bank credit in excess of this limit was subject to a marginal reserve requirement of 200 per cent of the excess. Introduced for a period of one year, this measure was expected to be in effect only temporarily. However, in November 2005, the BNB announced that, as a precaution, the measure would remain in effect until the end of 2006 when Bulgaria expected to join the EU. Moreover, observing that some banks chose to pay the penalty deposits and continued to lend beyond the credit limits, the BNB temporarily raised the marginal penalty deposits to 400 per cent of the excess (IMF 2007: 56).

Some banks complied with the credit expansion limits, but others preferred to pay the penalty rates or circumvented the measures altogether (Petkova and Manolov 2007). Several banks continued to exceed the credit limits even after the penalty deposits were increased to 400 per cent. Apparently, the banks’ lending margins remained sufficiently high to compensate for the high penalty rates. The total collected penalty deposits amounted to 1 billion leva, almost 2.5 percent of GDP and 10 percent of reserve money (IMF 2007: 57). Another strategy was to circumvent the measures altogether. To do this, banks sold part of their loan portfolio to either foreign banks or Bulgarian non-bank financial institutions (IMF 2007: 57). All in all, once the more restrictive measures expired at the end of 2006, credit growth accelerated again, reaching 56 per cent in September 2007 (IMF 2007; EBRD 2012).

As the effects of the global financial crisis were felt across Central and Eastern Europe in 2008-2009, the BNB initiated a thorough review of the banks’ risk profiles and shock-absorbing capacity (BNB 2008: 44). The Central Bank was particularly adamant to preserve the accumulated capital buffers and compel banks to bolster their capital reserves. The BNB amended ordinance 9 concerning risk exposures and provisions for credit risk and ordinance 8 concerning capital adequacy. These measures sought to ensure more responsible provisioning against losses and create options to renegotiate existing loan contracts (BNB 2009: 45). Roumen Simeonov, Head of Banking Supervision at the BNB, attributes the adjustment of banks’ aggressive lending after 2008 not just to the measures taken by bank supervisors but also to the more centralized risk management policies developed within foreign banking groups. In his view, this had a risk-reducing effect on their domestic branches and subsidiaries (Personal interview, Simeonov 2012).

To sum up, the Bulgarian Central Bank has applied consistently a risk-averse approach and has intervened pro-actively with counter-cyclical measures. However, the case study showed that the high level of foreign ownership in the sector under an open capital account created opportunities for the branches and subsidiaries of foreign banks to circumvent the Central Bank’s policy measures aimed at restricting credit growth. Furthermore, according to long-term bank supervision professional, Tatyana Petrova, it would be difficult to maintain banking sector stability in conditions of prolonged economic contraction (Personal interview, Petrova 2012). Thus, it remains to be seen whether the Bulgarian banking system can handle the growing number of non-performing loans shown on Figure 4.
Section IV: Estonia

After Estonia joined the European Union in 2004, the country experienced capital inflow from abroad, channeled into consumption credit to individuals and households as well as purchasing real estate (Lamine 2009). Furthermore, credit growth accelerated over time: gross debt liabilities increased on average by 32 per cent over the period 2005-2007, compared to 20 per cent over the period 2000-2004 (Lamine 2008: 3). The rapid credit growth and a real estate bubble in the mid-2000s posed a serious threat to banking sector stability in Estonia (Kattel and Raudla 2013; Bohle 2013).

Estonian bank supervisors closely observed these developments and introduced a series of pro-active measures in an attempt to cool off the credit boom and enhance financial sector stability. The Estonian Central Bank, Eesti Pank, stressed that its regulatory approach was more restrictive and risk-averse than prescribed by the common EU regulatory framework (Eesti Pank 2009). The Central Bank saw its primary function as “ensuring the capitalization and liquidity of banks on a level sufficient to keep the stability and reliability of the banking sector from declining amid changes in the economic cycle” (Eesti Pank 2009).

Some of the risk management measures adopted by the Eesti Pank stemmed from approximation with European and international standards. For example, in 2006, the bank introduced a new procedure to calculate bank capital adequacy, based on the EU’s Capital Requirements Directive (CRD). At the same time, the Eesti Pank kept the capital adequacy ratio at 10 per cent, while the minimum level prescribed by Basel II was 8 per cent. In 2006, the Estonian Central Bank raised the risk weighting of housing loans, used for calculating capital adequacy, from 50 to 100 per cent. Effectively, this meant that banks had to hold more capital as provisions for the housing loans they issued. The Central Bank estimated that these measures helped to increase banks’ capital buffers by approximately 13 per cent (Eesti Pank 2008). According to the Basel II framework, implemented in the EU through the CRD directive, housing loans should carry a risk weight of 35 per cent. When transposing the CRD, the Eesti Pank established a two-year transition period, during which it maintained higher risk weights. Subsequently, in compliance with the CRD, the risk weighting requirements for housing loans dropped to 35 per cent in 2009 (Eesti Pank 2009).

Since the beginning of transition, Estonia has pursued a market-oriented path of economic reforms, which is visible in the early privatization of state-owned economic assets and low taxation levels (Kattel and Raudla 2013). At the same time, the Central Bank has consistently set a more stringent banking supervision policy, requiring higher capital adequacy levels than stipulated in international agreements. According to a bank supervision professional, reporting standards are rather strict in Estonia, which allows supervisors to update their information more often and react faster to new developments. For example, reporting deadlines are shorter than the EU average, which is also the case in Bulgaria (Personal interview, Estonian Financial Supervision Authority 2011). Furthermore, off-site supervision is quite intensive. Partly due to resource constraints, the same staff members are involved in both off-site and on-site supervision. This minimizes the loss of information and allows supervisors to have a more comprehensive understanding of the risks on banks’ balance sheets (Personal interview, Estonian Financial Supervision Authority 2011).

The Governor of the Estonian Central Bank, Vahur Kraft, has pointed out that the Central Bank goes beyond micro-prudential supervision measures and takes into account business cycles when discussing changes to the regulatory framework (Kraft 2003: 10). He stressed that
the early warning systems approach was still used by the Eesti Pank to identify risks in the financial system, but it was complemented by macro-prudential analysis, drawing on policy recommendations from the Bank for International Settlements (BIS), the European Central Bank (ECB), and the International Monetary Fund (IMF) (Kraft 2003: 11).

In the early 2000s, considering the rapidly developing economy and currency board arrangement, Estonian supervisors aimed to build up liquidity buffers and sufficient capital to withstand asset price fluctuations. According to Central Bank Governor Kraft (2003: 13), a counter-cyclical regulatory approach is particularly useful for currency board regimes, where an active use of monetary policy measures is not possible and reserve requirements are essentially the only available monetary tool. Estonian supervisors set a relatively high reserve requirement at 13 per cent of the banks’ liabilities, half of which the banks could hold in high quality foreign assets (Kraft 2003: 13).

Yet measures such as increasing the risk weights of housing loans and the mandatory reserve requirements did not slow down credit growth substantially. A bank supervision professional stressed that the foreign-owned banks should not be blamed for channeling capital to Estonia, as the unprecedented domestic demand for loans was a powerful driver of the credit boom. According to the interviewee, supervisory measures alone could not slow down credit growth. She emphasized the importance of complementary government measures such as abolishing mortgage tax deductions, which would help reduce the incentives to take out mortgage loans (Personal interview, Estonian Financial Supervision Authority 2011). While the mortgage interest deduction has remained in place, in 2004, the Estonian government reduced by one half the upper limit on total tax deductible expenses, including mortgage interest payments (IMF 2004a: 3). It also tightened the eligibility criteria for obtaining mortgage down payment guarantees from Kredex, a government agency which provides mortgage guarantees to young families and vulnerable social groups (IMF 2004a: 3).

In the broader context of supervisory architectures in the region, Estonia stands out with establishing an effective institutional cooperation system among the financial stability units of the Finance Ministry, the Central Bank, and the Financial Supervision Agency (Personal interview, Estonian Finance Ministry 2011; Personal interview, Estonian Central Bank 2011). Whereas some new EU member states from Central and Eastern Europe are apprehensive about the dominance of foreign-owned banks, Estonia has been generally positive about the role of Scandinavian banks in the country. The Central Bank views the integration of the Estonian financial system with that of the Nordic EU member states as a strategic guarantee for financial sector stability, as Nordic-based banks account for 95 per cent of the Estonian banking market (Eesti Pank 2009).

Becoming an integral part of Nordic financial groups has assuaged Estonian bank supervisors’ immediate concerns about liquidity in the system and banks’ capital adequacy. Estonian bank supervisors signed cooperation agreements with their counterparts in the other Baltic countries, Sweden, Denmark, Norway, Finland, and Germany in the early 2000s (Kraft 2003: 12). Furthermore, in August 2010, a Nordic-Baltic Memorandum of Understanding (MoU) on financial stability, crisis management and crisis resolution was signed by the Ministries of Finance, Central Banks, and Financial Supervision Authorities of Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden (EBRD 2012: 55).

An expert from the Estonian Finance Ministry has highlighted that in addition to multilateral cooperation initiatives such as the NBSG discussed above, Estonian regulators
maintain close bilateral cooperation with their counterparts in Sweden and Denmark (Personal interview, Estonian Finance Ministry 2011). These are the home jurisdictions of the most important foreign-owned banks in Estonia. Looking at the structure of banking in the Baltic-Nordic region, the same set of banking groups such as Nordea, Handelsbanken, and SEB (Skandinaviska Enskilda Banken) are active across the area. Bank managers and bank supervisors in the home jurisdictions of these cross-border groups see regional financial stability as a shared goal. According to the interviewee, these actors think of the ‘home’ market not as narrowly based in their own jurisdiction but on a regional level (Personal interview, Finance Ministry 2011). He acknowledged that the dependency on capital from Scandinavian banking groups is a potential vulnerability. However, the interviewee stressed that Estonia is a small open economy and absent sufficient domestic capital, reaching out to foreign providers of financial services was a strategic choice (Personal interview, Estonian Finance Ministry 2011).

As shown on Figure 1, since 2008, the Estonian banking system has remained well-capitalized by European standards. One institutional factor that stands out in the Estonian case is the effective working relationship of the Central Bank, Finance Ministry, and Financial Supervision Authority (Personal interview, Estonian Finance Ministry 2011; Personal interview, Estonian Central Bank 2011). This has allowed the Central Bank to maintain a risk-averse supervisory approach since the beginning of transition despite the overall free-market path of economic reform pursued by Estonian governments. At the same time, we need to highlight that the readiness of Swedish banks to support their Estonian branches and subsidiaries with capital was crucial to make the Central Bank’s regulatory approach work and ensure financial stability after the 2008 global financial crisis.

Section V: Hungary

Hungary was an early reformer in Central and Eastern Europe and apart from the banking crises in the early 1990s, its banking sector was stable until the 2008 global financial crisis. However, as early as 2005, the IMF (2005) expressed concerns over the rapid increase in foreign currency loans in Hungary. Driven by advantageous international interest rates and a relatively stable exchange rate, household borrowing in foreign currencies such as euro, Swiss franc, and Japanese yen increased from about 10 per cent of total household loans at the end of 2002 to 25 per cent in September 2004. In 2005, almost all new loans were denominated in foreign currency (IMF 2005). The IMF’s main advice to tackle the potential negative effects of foreign currency lending was to provide better information to borrowers about the risks of foreign exchange loans. This measure was indeed adopted and bank customers received more detailed information about the effect of exchange and interest rate movements on servicing their loans. At that time, neither the HFSA nor the Hungarian National Bank – Magyar Nemzeti Bank (MNB) considered more hands-on regulatory measures to be appropriate. The MNB (2005) cautioned that any such measures should be in line with EU prudential regulation directives and should not distort competition.

Foreign currency loans continued to grow as percentage of total lending and in 2008 the MNB and HFSA issued a joint statement warning Hungarian banks that aggressive lending practices created systemic risks and jeopardized financial stability. They also pointed out laxness in the loan qualification system and warned that “the system may not be circumvented in the interests of increasing lending volume” (HFSA and MNB 2008). Overall, until 2008, the regulatory approach was largely market-based and assumed that market participants would
adjust their lending strategies if they were provided with more information. The HFSA and MNB (2008) stated that they “expect financial institutions to exercise self-regulation and self-restraint.” As a measure of last resort, the HFSA mentioned it was prepared to “use all means available to limit the development of additional risks, including the consideration of possible surplus capital requirements” (HFSA and MNB 2008).

Eventually, it became clear that the market-based mechanism of informing customers about the risk of foreign currency lending and warning banks to rein in their aggressive lending practices was not producing the desired outcomes. In February 2008, the Central Bank (MNB) and the Financial Supervision Authority (HFSA) issued a joint recommendation concerning the systemic risks created by foreign currency lending. As evidence of the growing credit risk, they stressed that “for more than one half of newly originated housing loans, the loan amount now exceeds 70 per cent of the collateral value, and 90 per cent of new loans to household are based on foreign currencies” (HFSA and MNB 2008). The two organizations pointed out that, compared to other EU countries, the high percentage of foreign currency denominated loans was a substantial risk for banking sector stability in Hungary.

The IMF also highlighted in its 2008 report that Hungarian banks were adopting ever riskier strategies to maintain or enlarge their market share such as relying on foreign interbank deposits and debt securities. These sources, however, are associated with greater liquidity risks than traditional deposits (IMF 2008: 22-23). By 2008, reliance on foreign capital had become the main economic development strategy for many countries in the region (Bohle 2013). The Hungarian National Bank was concerned that the over-reliance on external capital and, in particular, on short-term loans from the international capital markets would jeopardize the stability of the Hungarian banking system (Personal interview, Hungarian National Bank 2012). According to the MNB’s analysis, a domestic loans-to-deposits ratio exceeding 110 per cent is very risky and unsustainable in the long run. In Hungary, this ratio stood at 119 per cent in 2004, reaching a peak of 160 per cent in 2008 (Hungarian National Bank 2003-2009).

Hungary was one of the countries in Central and Eastern Europe that had to resort to IMF loans to stabilize its balance of payments in the aftermath of the global financial crisis. It borrowed funds from the IMF under a Stand-by Agreement which was active in the period 2008-2010. The fund’s consultation with the government in December 2008 led to granting a new set of emergency powers to the HFSA. In cases of serious threats to financial stability, the HFSA could impose additional reporting requirements on banks, demand a higher bank capital adequacy ratio, and intervene in the supervision of subsidiaries when the parent banks experienced financial difficulties (IMF 2008: 22-23).

Yet, a few years later, the institutional changes introduced after the 2008 crisis were reversed. The government, working together with parliament where it had a large majority, reinstated mechanisms for political control over supervisory decisions. The so-called Fiscal Council, introduced under the Financial Responsibility Law to safeguard fiscal discipline, was replaced by a smaller body consisting of the chairman of the State Audit Office, the Governor of the MNB, and a presidential appointee. This council still has formal veto power over the state budget, but its mandate and resources were curtailed. A new law revoked the powers of the Financial Stability Council to initiate new legislation or regulatory measures on a ‘comply or explain’ basis (IMF 2011a: 21-23). Moreover, in March 2009, the Hungarian government decided to provide uncollateralized loans to three troubled banks in order to keep them solvent. The largest domestic bank, OTP, received €1.4 billion, the state-owned development bank,
MFB, received €600 million, and a mortgage lender, FHB, received €400 million (IMF 2011a: 21-23).

With respect to the role of foreign-owned banks, during the brief period of sustained economic growth, many experts and practitioners assumed that foreign banks would always step in to recapitalize their subsidiaries in Central and Eastern Europe (Personal interview, Hungarian National Bank 2012). Janos Müller from the Hungarian Association of Banks confirmed this view and pointed out that foreign-owned banks had a stabilizing effect in the Hungarian banking system during the crisis (Personal interview, Müller 2012). The parent banks, by and large, supported their Hungarian subsidiaries. However, he observed stagnation in the banking sector since 2008 and expressed concern about the policy of the Hungarian government to impose the highest bank levy in the EU (see also Bryant 2010; KPMG 2012). In 2011, for example, the Hungarian banking sector made a loss of about 100 billion HUF. In addition to the bank levy, the government adopted measures that allowed bank customers to renegotiate the terms of their mortgage. In practice, this initiated a wave of early mortgage repayments by the banks’ most reliable customers who could afford to keep making their mortgage payments in the future (Personal interview, Müller 2012).

Hungary was one of the first countries in the region to introduce integrated financial supervision in an independent agency, the HFSA. Yet, somewhat surprisingly, in the course of 2013, the Hungarian government reversed this institutional decision and transferred supervisory responsibilities to the MNB (Budapest Times 2013; Portfolio.hu 2013). The initial opinion of the ECB on the merger of the two institutions was favorable, but it emphasized that this move should not endanger the functional and financial independence of the MNB (ECB 2013a: 3-4). The ECB also warned the Hungarian government that the new law did not envision a sufficient transition period to allow a smooth transfer of the HFSA’s micro-prudential supervision functions, which could lead to legal uncertainty.

In sum, in the Hungarian case we observed the most politicized dynamics of banking supervisory policy among the four countries. Until 2007, the supervisory approach was predominantly market-based and relied on improved information provision about financial risks to banks and customers. After 2007, regulators took pro-active measures such as tightening supervision and raising the capital requirements (Geršl and Jašová 2012). The dominant role of the executive branch and the decision to delegate financial supervisory tasks to an agency rather than to the Central Bank meant that the government could influence the banking supervisory approach more easily than in the other three countries examined here. Even after a surprising merger of the HFSA and the MNB in 2013, the ECB still questioned the extent of functional and financial independence of the MNB and asked the Hungarian government to provide further legal safeguards (ECB 2013b: 5-6).

Section VI: Slovenia

In the beginning of transition, the Slovenian government and businesses had a strong preference for preserving domestic ownership in the financial sector (Piroska 2009). This view was shared by the board members of the Central Bank (Personal interview, Bank of Slovenia 2011). Compared to other countries in the region, Slovenia also had access to a larger pool of local capital in the beginning of transition. Relying on the available domestic capital, Slovenian governments preferred to privatize the enterprise sector to Slovenian owners rather than to foreign strategic investors. According to an expert from the Ministry of Finance, the decision
to maintain state ownership in banking was political rather than driven by desire to maximize revenue for the state from banks’ profits (Personal interview, Slovenian Finance Ministry 2011).

The Slovenian banking system was well-capitalized in the period 1995-1999, but in 2000, the Bank of Slovenia observed in its annual report that the capital adequacy ratio was decreasing (Bank of Slovenia 2000). As shown on Figure 1, from 2001 to 2004, the capital adequacy ratio fluctuated within a relatively narrow band between 11.1 per cent and 11.9 per cent, but it fell below 11 per cent in 2005. Even though this level was still higher than the 8 per cent prescribed by Basel II standards, the Central Bank was concerned about the rapid credit expansion, which it saw as the main reason for the declining bank capitalization. Still, it refrained from adopting hands-on measures in the early 2000s (Bank of Slovenia 2002).

In anticipation of EU accession, Slovenia experienced high net capital inflows in the early 2000s. The non-performing loans and risky assets on banks’ balance sheets increased as well. In 2002, bank supervisors noticed a series of irregularities during their routine bank inspections such as inadequate internal controls of credit risk, incorrect calculation of capital and capital adequacy, and inadequate control of foreign exchange or market risk (Bank of Slovenia 2002). In response, the Central Bank issued 16 orders for the correction of operating irregularities and a series of recommendations for improvements in banks’ internal risk management practices. Furthermore, the Bank of Slovenia closely monitored banks’ liquidity ratios. In October 2001, the Central Bank passed a decision on the minimum required level of liquidity, which unified the monitoring of local and foreign currency liquidity reserves with shorter reporting requirements (Bank of Slovenia 2001). The Central Bank adopted a more pro-active approach in 2003 when three banks reported a capital adequacy ratio below 10 per cent, and one bank – even below 8 per cent. On that occasion, bank supervisors issued an order to bring the bank in line with the minimum required capital adequacy ratio by the end of April 2004 (Bank of Slovenia 2003).

Slovenian banks gained easier access to cheap international capital when the country joined the EU in 2004. During the period 2004-2008, bank supervisors were concerned about the rapid credit expansion and considered introducing measures to slow it down. They observed 30-40 per cent annual increase in total loans, whereas deposits grew annually by only 6-7 per cent. To meet the demand for loans, domestic banks borrowed on the international capital markets with different roll-over arrangements, most of which were for 3-5 years (Personal interview, Slovenian Finance Ministry 2011). Slovenian banks relied heavily on borrowing from foreign institutions. For example, in 2005, Austrian banks held 40 per cent of all foreign liabilities of Slovenian banks (IMF 2006).

In the case of foreign-owned banks, incoming capital from the parent banking groups led to a 70 per cent increase in total assets in 2004. At the same time, the Central Bank pointed out that foreign-owned banks had developed high-quality portfolios; the portion of claims on their balance sheets in the above-average quality ‘category A’ was 91.2 per cent (Bank of Slovenia 2004). Banks continued to fund their expanding lending through syndicated loans or, in the case of foreign-owned banks, the parent banking groups. However, according to the IMF’s assessment, “the resulting build-up of external debt represent[ed] a potential vulnerability” for the stability of the Slovenian financial system (IMF 2004b). The Central Bank introduced some restrictions such as requiring higher provisions for loans, but these measures had little impact on the growing demand for credit by both citizens and businesses (Personal interview, Bank of Slovenia 2011).
In 2006, the IMF also highlighted the vulnerabilities in the Slovenian banking system due to rapid credit growth. As the pressure on bank profit margins increased, the IMF advised Slovenian banking supervisors to be vigilant and maintain high credit standards in the banking system (IMF 2006). The fund expressed concerns that the level of provisioning in the Slovenian banking system was relatively low despite the measures taken by the Central Bank. It warned that implementing the new International Financial Reporting Standards would effectively decrease that level even further (IMF 2006). In response, the Central Bank introduced a temporary measure to classify any released provisions as reserves. This measure alleviated the problem in the short run, but it did not address the long-term vulnerability of low provisioning against non-performing loans.

Against the backdrop of very high foreign ownership in the banking sector across Central and Eastern Europe, Slovenia's domestic-owned banks managed to maintain a large market share in Slovenia throughout the period of rapid credit expansion. At the same time, the Central Bank’s Banking Supervision department actively sought to establish a good working relationship with the home supervisors of foreign-owned banks to limit the risks of contagion and create coordination channels in case of financial crisis (Bank of Slovenia 2006; IMF 2006). Regulators generally anticipated that, if needed, parent banks would inject capital in their Slovenian subsidiaries.

The 2008 global financial crisis triggered an economic contraction in the region. As a result, Slovenian bank supervisors anticipated a sharp increase in debt defaults by citizens and companies (Bank of Slovenia 2008). Similarly to the Hungarian case, in Slovenia, banks started to adjust their market behavior only after the effects of the 2008 global financial crisis had become evident. Both domestic and foreign-owned banks restricted their lending procyclically, which in turn affected the real sector. Due to the adjustment in bank lending, companies lost access to affordable long-term loans in order to cope with the economic downturn (IMF 2009).

In 2010, the Bank of Slovenia (2010) warned that the banking system may need a fresh round of recapitalization and bank privatization was put on the table as one possible solution. Since the 1990s, Slovenian governments have been reluctant to resort to privatization as a way to recapitalize and stabilize the banking system. Similarly, in 2011, the government was willing to try out any other available options first. In 2011, domestic banks’ liquidity needs were covered using funding from the European Central Bank through a three-year long-term refinancing operations program (LTRO). Despite these efforts, the portfolios of the largest domestic banks continued to deteriorate. Compared to other Eurozone countries, Slovenia experienced the most severe period of economic contraction after 2008, with the exception of Greece (IMF 2012). The quality of bank assets declined further in 2012 after continued defaults, especially by large firms in the construction sector. The largest publicly-owned bank, Nova Ljubljanska Banka (NLB), received a capital injection of €383 million in June 2012 to remain solvent (Slovenia Times 2013a). In general, Slovenian banks continued to rely on government deposits and ECB financing to remain liquid. This strategy stabilized them in the short-term, but failed to resolve the underlying problems in the sector.

In October 2012, the Slovenian parliament adopted a new law on financial stability which created the Bank Asset Management Company (BAMC), a government agency which can issue government-guaranteed bonds worth a maximum of €4 billion (about 11 percent of Slovenia’s GDP) in order to seek a quick resolution of impaired bank assets (IMF 2012: 9-10). Following
an extensive banking system stress-test mandated by the EU, the government announced in December 2013 that it would begin the recapitalization of three state-owned banks NLB, NKBM, and Abanka (Slovenia Times 2013d). The NLB is scheduled to receive €1.55 billion, almost half of the total recapitalization package. In addition, €870 million are allocated for NKBM and €591 million – for Abanka. Another €445 million are set aside for Probanka and Faktor banka, which are undergoing a controlled wind-down (Slovenia Times 2013d). NLB and NKBM began transferring their non-performing loans in December 2013, while Abanka still has to prepare a restructuring plan and submit it for approval to the European Commission (Slovenia Times 2013d). An important implication of establishing the BAMC is that once the state-owned banks have been restructured and recapitalized, they can be privatized. However, the Slovenian government has stressed in its annual consultation with the IMF that reducing public ownership of the banks below the blocking minority share of 25 per cent would require broad political support (IMF 2012: 12).

Overall, the Bank of Slovenia took measures to build higher provisions and maintain adequate levels of bank capitalization during the rapid credit expansion in the mid-2000s. It paid special attention to monitoring liquidity and capital adequacy. However, the country’s banking system was destabilized by the limited structural capacity of domestically-owned banks to meet the high demand for loans during the early and mid-2000s and, subsequently, absorb the growing percentage of non-performing loans after 2008. The recent domestic bank rescue package may change the long-standing political commitment to state ownership. According to the government’s restructuring plans for the banking sector, NKBM should be sold off completely by 2016 and NLB should be privatized by 2017, but the state should retain 25% plus one share in the bank (Slovenia Times 2013c).

**Section VII: Maintaining national discretions in a single rulebook supervisory regime**

The dilemma in harmonizing European banking supervision is similar to the one faced by countries in the Eurozone. A common monetary policy cannot be tailored to the specific circumstances of each member state. Similarly, a common banking supervision regime cannot be tailored to the risk-tolerance profile and concerns of each member state, which raises decision-makers’ sensitivity toward a full-scale transfer of regulatory authority away from the national level. This is not to say that new EU member states deny the need to eliminate some national discretions in order to ensure a level playing field. After all, substantial progress toward more harmonization in EU banking regulation has been made since 2008.

For example, the single rulebook was developed to provide set of harmonized prudential rules applicable to all EU member states (European Commission 2013a; 2013b). Still, discussions about the single rulebook in the latest revised version of the Capital Requirements Directive (CRD IV) and the Capital Requirement Regulation (CRR) reveal disagreements about the optimal scope of regulatory harmonization (Spendzharova 2014). All EU member states recognize the need to eliminate some national discretions in order to achieve and sustain regulatory harmonization in the EU. At the same time, many country positions in the Commission’s stakeholder consultation ask for a careful assessment of which national options and discretions need to remain in place, because they are crucial for the functioning of national supervisors. For example, countries insisting on the preservation of national discretions have argued that some markets in the EU such as foreign currency lending and real estate mortgage finance are still segmented and show divergent dynamics at the national level. Taking away
the discretions of national supervisors to impose stricter rules in response to local imbalances could, in the end, be detrimental for national financial stability (European Commission 2011b).

Is there evidence that countries adopting a risk-averse regulatory approach early on such as Bulgaria and Estonia insist on preserving national discretions under the single rulebook regime in banking supervision? The common position of the Bulgarian Central Bank, Ministry of Finance and Financial Supervision Commission stressed that Bulgarian supervisors would prefer to maintain “the ability to take the necessary actions and measure to protect the interests of investors and the stability of the national financial markets” (Bulgaria 2009: 2). They agreed that unjustified national discretions should be eliminated, but insisted on preserving some key national discretions which are important for national financial stability (Bulgaria 2009: 3). From a European perspective, a real estate bubble in Bulgaria may look like an isolated threat to the Union’s financial stability, but national supervisors wanted to keep the powers to impose stricter capital requirements than the commonly agreed European levels. Similarly, the position of the Hungarian Central Bank (2009: 2) pointed out that due to variation in legal systems and banking structures and practices across the union, it “cannot yet support the creation of a single, uniform rule book for the community as a whole.”

Estonia was willing to give up some national discretions “in the name of larger harmonization and far-reaching EU Single Market” but it also advocated the renewal of national discretions and flexibility mechanisms, especially in the realm of crisis management (2009: 5). The joint position of the main Estonian public regulators on amending the Capital Requirements Directive (CRD) explained that national discretions contributed significantly to preserving relative stability in the Estonian banking system in the aftermath of the 2008 global economic turmoil. Banking regulators had put in place several counter-cyclical measures such as a 10 per cent minimum capital requirement for all credit institutions, and an increase of mortgage credit risk weight in 2006 to curb the rapid credit expansion. They saw these national discretions as important and preferred to keep them in the new European regulatory regime (Estonia 2010: 13-14).

During the inter-institutional negotiations of CRD IV and CRR, the member states that had reservations about maximum harmonization obtained concessions in several areas where the national supervisory authorities may set stricter requirements than the common European framework. For example, member states retain the discretion to set higher capital requirements if they observe vulnerabilities in real estate lending (European Commission 2013b). This provision allows them to intervene in an attempt to cool off real estate bubbles. In addition, member states may calibrate the level of the counter-cyclical buffer based on the condition of the domestic economy and threats to the country’s financial stability (European Commission 2013b). The Basel III framework, and consequently the CRD IV package, also retain a provision in Basel II concerning the so-called pillar 2, which allows bank supervisors to impose additional requirements on a specific bank based on their risk assessment (European Commission 2013b).
Section VIII: Conclusion

This paper probed the effectiveness of counter-cyclical regulatory tools at the national level and concluded that they can be circumvented by both banks and governments, which disagree with bank supervisors’ approach. The case studies focused on four countries which implemented counter-cyclical measures to varying degrees: Bulgaria, Estonia, Hungary, and Slovenia. The Bulgarian Central Bank applied consistently a risk-averse approach and intervened with counter-cyclical measures such as requiring higher provisions against bad loans and putting in place mandatory limits on the rate of credit expansion. In Estonia too, the Central Bank has used a risk-averse supervisory approach. In the Hungarian case, until 2007, the supervisory approach was predominantly market-based and relied on improved information provision about financial risks to banks and customers. In Slovenia, the Central Bank took measures to build higher provisions during the period of rapid credit expansion and closely monitored liquidity.

I analyzed a range of counter-cyclical policy tools such as increasing the risk weights of mortgage loans on banks’ balance sheets, capping the share of foreign currency loans in banks’ portfolios, and requiring higher capital adequacy ratios than internationally agreed levels used in the four countries during the credit booms in the mid-2000s. These measures capture the broad spectrum of counter-cyclical regulatory tools introduced by Basel III, and subsequently CRD IV and CRR. The evidence suggests that counter-cyclical regulatory measures can only mitigate risks in the short-term. Their effectiveness is rather limited unless the ruling government and private sector actors synchronize their actions with those pursued by bank regulators.

Finally, the experience of managing the domestic credit booms and, subsequently, the effects of the 2008 global financial crisis have made an impact on the regulatory preferences of domestic bank supervisors in Central and Eastern Europe. Especially countries that adopted a risk-averse regulatory approach early on such as Bulgaria and Estonia stand out with their insistence on preserving national discretions in the European single rulebook regime.

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