LJUBLJANSKA BORZA

SLOVENE CAPITAL MARKET DEVELOPMENT STRATEGY

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cee stock exchange group

Initiative by market stakeholders

A well developed capital market provides a wide range of capital structure resources. Economic growth is stimulated through lower cost of capital, improved structure of financing and better allocation of funds. On the other hand, the actual benefits of a well-developed capital market depend on the specific economic situation, which has changed significantly in Slovenia with the onset of the financial and economic crisis. The crisis exposed some of the hidden weaknesses of our economy, and a better performing capital market could contribute to solving them. The main areas where the Slovene capital market could be a major supporting player in restructuring are:

- pension reform and all forms of saving for old age;
- deleveraging and improving the capital structure of Slovene companies;
- greater stability in financing development from abroad;
- improved corporate governance and lower risks related to company performance;
- additional opportunities for the state's withdrawal from companies through IPOs;
- strengthening the international competitiveness of Slovenia's financial sector.

The main focus has to be stabilisation, restructuring and future growth of the Slovene economy. Accepting the concept of private property and acknowledging the positive role of capital are crucial to establishing the trust required for boosting new investments, and they are also the necessary precondition for attracting funds from non-company-related investors. All major market participants – including the state – must achieve a high level of consensus about these measures as well as become actively involved in their implementation.[1]

The required measures and activities should be drawn up along the following lines:

- level playing field for domestic and foreign service providers;
- level playing field for domestic and foreign financial products;
- the state – as an owner – has equal rights as the other shareholders;
- the state – as an investor – has the same position on the market as the other market participants;
- elimination of transitional institutional market regulation;
- strengthening international standards and business practices;
- international comparability of trading and settlement systems;
- searching for cost efficient solutions tailored to the market's size;
- due to the lack of confidence in the financial system, measures to strengthen market transparency and stable operations should be prioritized.

[1] The new strategy for development of the capital market was drafted based on the initiative proposed by the Ljubljana Stock Exchange, proposals by market participants and the research conducted by the Slovene Institute for Economic Research (IER) entitled »Development Opportunities for the Capital Market in Slovenia Following the Financial Crisis« (2010), with contributions from **Marko Simoneti PhD, Kruno Abramovič MA, Aleš Berk Skok PhD, Jože P. Damijan PhD, Igor Masten PhD, Simon Mastnak MA, Mojmir Mrak PhD, Matija Rojec PhD, Janez Šušteršič PhD, Luka Vesnaver MA.**

The post-crisis capital market in Slovenia is struggling and requires a systemic proactive approach. Measures must be adopted to stimulate domestic and foreign demand for securities, as well as to encourage Slovene issuers to place quality and diverse stocks and bonds on the market. Market infrastructure and business practices must become fully aligned with international standards, so as to rebuild market confidence.

The key drivers of market development are market participants (financial intermediaries, infrastructure providers). The financial industry represents the infrastructure and mechanisms required to reach the set objectives, provided that the proposed measures are carefully and efficiently planned and implemented.

Given the recognized opportunities, as well as the possibilities and proposals provided by market participants, the state is a partner in enforcing the Strategy: as the authority which is expected to set up an efficient institutional framework for the operation and development of the capital market, as a powerful owner of a large segment of the economy, and as a stakeholder who is directly or indirectly a very important market player.

The lack of foreign investors in our market reflects the stage of the Slovene economy and the situation on the market. It does certainly not encourage portfolio investments, neither from Slovenia nor from abroad. The quality and liquidity of the Slovene capital market can only be improved through the right combination of measures, which will affect all of the mentioned factors simultaneously. These measures fall into the following three groups, which are presented into detail below:

- measures and activities boosting market confidence and increasing market quality;
- measures and activities stimulating demand;
- measures and activities stimulating supply.

1. MEASURES AND ACTIVITIES BOOSTING INVESTOR CONFIDENCE AND MARKET QUALITY 4

1.1. NATIONAL STEERING COMMITTEE FOR ALIGNED CAPITAL MARKET DEVELOPMENT 4

1.2. INCREASED AWARENESS OF THE IMPORTANCE OF A WELL-FUNCTIONING CAPITAL MARKET 4

1.3. SUCCESSFUL INTERNATIONAL IPOS...4

1.4. INTERNATIONALLY COMPARABLE CAPITAL MARKET REGULATION 5

1.5. IMPROVED INVESTOR PROTECTION...5

2. MEASURES AND ACTIVITIES STIMULATING DEMAND...6

2.1. DEVELOPMENT AND EQUAL TREATMENT OF ALL TYPES OF SAVING FOR OLD AGE 6

2.2. SYSTEMATIC INTERNATIONAL PROMOTION OF THE CAPITAL MARKET 7

2.3. STIMULATING STOCK BONUS PLANS...8

2.4. A COMPETITIVE TAXATION SYSTEM SUSTAINABLE IN THE LONG-TERM 8

3. MEASURES AND ACTIVITIES STIMULATING SUPPLY 9

3.1. PROMOTING A BALANCED CAPITAL STRUCTURE OF SLOVENE COMPANIES...9

3.2. OWNERSHIP DISPERSED AMONG PORTFOLIO INVESTORS 9

3.3. RESTRUCTURING THE STATE'S INVESTMENT PORTFOLIO..10

3.4. SETTING UP A SLOVENE MARKET FOR CORPORATE BONDS 10

3.5. SYSTEMATIC LISTING OF COMPANIES...11

1. MEASURES AND ACTIVITIES BOOSTING INVESTOR CONFIDENCE AND MARKET QUALITY

1.1. National steering committee for aligned capital market development

The steering committee would be in charge of revitalising the capital market and would include senior representatives from the public and private sector, who adopted an action plan and monitored its implementation. The situation in Slovenia requires such a Group to feature all market regulators, representatives from the Ministry of Finance and the Tax Administration, representatives from LJSE and KDD, representatives of the major issuers and the biggest financial institutions. To ensure that the project of revitalising the capital market receives due attention of the executive and legislative branches of government in their programmes, the steering committee would have to be headed by one of the members of Government or its authorised representative.

It is recommended that the Slovene Government set up a steering committee for aligned capital market development, and that the steering committee prepare as soon as possible a detailed action plan of the necessary measures and activities as well as define the responsibilities of individual stakeholders for successful implementation.

1.2. Increased awareness of the importance of a well-functioning capital market

The financial crisis and stock market crash have caused a general crisis of confidence in the domestic capital market, confidence being lost by the general public, companies and politicians. Investor confidence can only be restored if people are informed of the benefits and importance that a well-functioning capital market has for the national economy as an exit from the crisis. In particular, the general public must accept the capital market as an opportunity to save for old age. Companies and their major domestic owners – including the state – have to understand that raising the shareholder culture in companies is a prerequisite for attracting domestic and foreign portfolio investors, and for increasing equity financing in deleveraged companies. Politics must understand that stock buyers are not merely greedy speculators, but first and foremost investors who assume business risk and provide domestic companies with a sound capital structure, which is vital for their international competitiveness. It is therefore necessary to change the way Slovenians see the capital market, and this can only be achieved through systematic and long-term educational and promotional activities.

1.3. Successful international IPOs

Foreign investment in Slovenia has been a series of unsuccessful attempts. It started at the time of custody accounts, and continued with numerous announced yet uncompleted cases of privatisation, foreign investments in Slovenia that failed to live up to initial expectations, as well as initiated and unfinished sales. This all had a long-term negative impact on the interest of foreign investors to place funds in Slovenia. This category also includes various tenders by state-owned funds, which were formally open to everyone but which lacked the suitable documentation for foreign investors and were thus in fact only intended for well informed domestic buyers. In Slovenia we are yet to understand the harm that this sort of half-way projects, where the influence of politics and interest groups prevails over economic logic, causes to the future development of our capital market.

In order to restore investor confidence, both in Slovenia and abroad, the Slovene market needs at least two successful IPOs conducted in line with international standards.

1.4. Internationally comparable capital market regulation

In order to make the Slovene market more internationally comparable and to attract domestic and foreign investors, market regulation needs to change, while market regulators and supervisors need to become more aligned in their operations. Future development should head in the following directions:

- regulation: simplification of procedures, equal treatment of comparable products and services, the regulators' commitment to market competitiveness and efficiency, including a transition from exercising control to actively regulating the market;
- trading: introduction of closing prices, international platform, foreign members, trading hours, market makers, listing partners, direct or indirect links to foreign markets;
- settlement: CCP, allowing settlement without membership in KDD, anonymity of portfolio investors, fiduciary accounts, direct or indirect links to foreign markets.

It is also important that those who need efficient price formation (asset value) most, because this is their principal activity, become key market players. Domestic institutional investors, major state and state-related owners, as well as companies listed on the regulated market (own shares) should be systematically included in the regular daily formation of official (closing) prices. In order to avoid potential conflicts of interests or breaches of regulated market rules and takeover restrictions, all activities must comply with the rules governing regulated markets and be subject to operating plans approved by the regulator.

1.5. Improved investor protection

Practical implementation of the Slovenian Corporate Governance Code

Slovene companies do not fully comply with the recommendations of the Corporate Governance Code: supervisory boards are only rarely composed independently or in the manner that avoids conflicts of interests, management boards are seldom replaced through business decisions but rather politically, certain management boards use company funds to take over businesses they were entrusted to manage, etc.

In order to improve corporate governance, it is necessary to strengthen the role, significance and responsibilities of the industry’s interest groups, such as the Slovenian Directors' Association, the Managers' Association of Slovenia, minority shareholders' associations, the Association of Stock Exchange Members, the Slovenian Investment Fund Association, and others. The state must also become actively involved in developing and reinforcing standards and good practices of corporate governance. The role of financial intermediaries in representing the interests of their clients in the field of corporate governance must also be strengthened.

A new method of managing state-owned companies

Complying with the Principles and Guidelines of the OECD, the Government has adopted a project that anticipates a reorganisation of the state's role as an equity partner. In order to prevent a conflict of interests between industry policy and the state's role as an equity partner, the role of the state as equity owner should be kept separate from its role as market regulator and further separated from its role of the trustee responsible for certain activities. Line ministries draft the industry policy that sets the guidelines for the development of industry branches, including the state’s goals with regard to investments; they draft industry legislation; they draft measurable goals to determine the performance of state-owned companies and the development of respective branches of industry. The implementation of this policy is to be transferred to a special central agency in the making, which will have the mandate to oversee the state’s investments. This will soundly centralise the functions of state property, lead to greater transparency in voting at shareholder meetings and in appointing members of management and supervisory bodies, and thus result in more efficient corporate governance. Domestic and foreign investors also expect the state to clearly state its position on what additional goals it may be pursuing in the companies where it holds a major stake.

Although the development of new corporate governance standards in state-owned companies is work in progress, it is important that the central agency defines the required standards of corporate governance as soon as possible and that all stakeholders are bound to periodical (quarterly) compliance reporting.

Improved IR

All too often Slovene companies treat their investors as »a necessary evil« instead of competing for their capital as is the case with competitors in developed markets. If foreign investors feel that they do not have the same access to information on the Slovene market as the major or local investors, they will not place their funds here. Merely setting standards is therefore not enough; what the Slovene market needs is specific funding to develop these areas and thus transpose the standards more efficiently into practice. Some opportunities in this field include:

- establishing quantified standards for drafting annual reports and websites (according to German, Austrian and Swiss examples); solid, quantified criteria help companies make improvements, as they show what is expected of them in advance;
- organizing a knowledge academy that would ensure the application of the latest IR know-how in Slovenia;
- establishing an IR society made up of IR officers from Slovene companies to serve as a venue for an exchange of experiences;
- establishing a society of Slovene financial analysts, which could make a considerable contribution to the development of IR standards, as it could engage in direct dialogue with the companies;
- stimulating capital markets research projects, student papers and study abroad.

Protecting the interests of minority shareholders

Consolidations of ownership by squeezing out minority shareholders have led to reduced minority shareholders' investor confidence. Further development of shareholding in Slovenia should be supported through:

- market participants educating retail investors;
- establish a system for direct or indirect participation of retail investors at company shareholder meetings;
- providing free legal assistance to retail investors (pro bono cooperation with law firms).

2. MEASURES AND ACTIVITIES STIMULATING DEMAND

2.1. Development and equal treatment of all types of saving for old age

Modernisation of pension funds in the 2nd pillar

A reform would have to touch on several areas, as the existing system, both in terms of scope, as well as in terms of the structure of investments, represents a missed opportunity to develop the domestic capital market. Furthermore, it does a poor job in performing its basic task of ensuring adequate returns given an acceptable long-term risk from the position of pension savers.

It would be essential for any reform to dismiss the mandatory investment policy with guaranteed returns and allow individuals to choose. In order to cater for collective pension savings, fund managers should offer a range of sub-funds tailored to predetermined age groups of savers (e.g. for three age groups: up to 45 years, up to 55 years and over 55 years). Individual age groups and their dedicated sub-funds should be subject to a minimum mandatory share of the conservative investment component.

Stimulating pension saving for individuals in the 3rd pillar (introduction of P accounts)

The individual part of supplementary pension savings should be separated from the collective part and provide individuals with additional tax incentives for pension savings. This is a reinforcement of »saving for old age for everyone«, which would also be partly linked to investments in Slovenian stocks and bonds, and could provide a decisive boost to the domestic capital market. Pension accounts ("P accounts") could allow individuals a free choice of financial products, whereby it would make sense to allow these types of funds to be pledged and be used for non-earmarked investments in case of very old age or in case of particularly long savings periods. For the purpose of transparency and due to the risks of changes in tax regulations, tax incentives should be provided in the same way as they were in stimulating housing savings. Individuals would therefore save in net amounts, while the state would add its own funds to annual payments in the form of tax credits.

We support the introduction of equal tax treatment and additional stimulation for all long-term forms of pension savings by individuals. Providers on the individual savings segment would be banks (deposits, structured or guaranteed products), insurance companies (with-profit life insurance and annuities), management companies (umbrella mutual funds), and stock brokers (management and brokerage in purchases of financial instruments).Those foreign providers who have a valid marketing licence in the Republic of Slovenia and who will guarantee due records and disclosure of data for tax and regulatory purposes should also be allowed to operate. The range of products that individuals may purchase within a respective supplementary pension system would not be limited, in principle.

Standardisation of pension annuities

Slovenia's three-pillar pension system provides for a pension annuity based on a collective scheme of supplementary insurance in the 2nd pillar, while we also propose a pension annuity based on the individual scheme in the 3rd pillar.

Striving for the development of the capital market, the essential issue is: to what extent is the sum of the annuity guaranteed and to what extent does it depend on the rate of return on assets invested in financial markets upon drawing on the eligible funds. Individuals could be entitled to more choice at the time of drawing on the annuities, and would thus also assume greater risk. The ability to assume risks of a long life does not depend solely on age, but also on an individual's income and financial position in old age.

Annuities received from the 2nd pillar are subject to tax, while annuities received from the 3rd pillar should be free of all taxes since they are based on investments from net (taxed) income. Both types of annuities allow for certain tax reliefs or incentives, which is why it is perfectly normal for the state to set minimum requirements that these financial products must meet.

2.2. Systematic international promotion of the capital market

In order to attract greater interest from foreign investors for Slovenian listed companies, and thus guarantee greater liquidity of domestic stocks, it is vital that the profile of the capital market be enhanced through active international promotion of the country, the Slovenian economy and the capital market. Possible activities in this field include:

- a national programme of promoting the Slovenian economy abroad;
- an annual programme of road shows with all major listed companies;
- integrating the international promotion of the market into major international IPOs;
- integrating the promotion of the capital market into international state commercial visits;
- promoting of the capital market through the diplomatic network;
- establishing English at all levels of informing by listed companies;
- including Slovene stocks into international stock indices.

2.3. Stimulating stock bonus plans

It would be necessary to simplify the administration and provide additional tax incentives for stock bonus plans for employees, which are still very limited in Slovenia. Stock bonus plans for employees should be voluntary and subject to a partner relationship between the employer and employees. It is only anticipated for public companies, while private companies would be subject to a complex financial scheme with deferred payments. Under the same tax terms private companies could have simple bonus plans for employees in the form of either stocks or coupons of the Slovene investment fund invested into Slovene public companies. In this way all employees who receive part of their income as stocks would contribute directly or indirectly to long-term equity financing of domestic companies, and they would thus become involved in the success of Slovenia's economy.

2.4. A competitive taxation system sustainable in the long-term

Simplifications in taxing capital gains and other capital income

Due to the ever greater complexity of the current system on the one hand, and the favourable basis offered by a shareholder relief taxation system on the other, we propose a systematic simplification of taxing capital income, which was also announced in the coalition agreement, and which will:

- regulate tax on income of private individuals in one single piece of legislation;
- be much simpler from an administrative point of view;
- be fiscally and budgetary neutral;
- treat all types of financial investments on equal terms;
- contribute to greater competitiveness.

The past few years have seen numerous proposals for amendments in the field of taxation of capital gains, with the aim to:

- establish a simple and administratively efficient system of taxing capital gains;
- establish a system of taxing capital gains which would provide taxpayers with a higher level of legal protection;
- improve neutrality in taxing different income from capital;
- ensure competitiveness of this tax system through investments of residents abroad.

Slovenia has introduced a tax on all capital income (interest, dividends, capital gains) with a uniform flat tax rate of 20%, which is reduced every five years by a further 5%. Excluding these taxes from the system of synthetic income allows various simplifications in collecting them, but they are being applied only to a limited extent: taxation of this income has long been subject to numerous exceptions in the form of exemptions, reduced tax rates, setting off losses and profits, recognition of various expenses, declaration of certain transactions and particularly specific annual income tax assessments.

Competitiveness and stability of tax sources in taxation of capital gains and other capital income

In a synergy of several measures a stable tax system that is sustainable in the long-term could stimulate a larger scope of investment and encourage the use of the capital market as a suitable source of financing. Possible measures in the field of tax regulation include:

- more favourable tax treatment of all forms of saving for old age;
- reduction of the sales period (currently standing at 20 years);
- tax exemptions for reinvested dividends;
- reduction of the tax rate on capital gains from derivatives;
- reduction of corporate income tax in case of balanced financing through the capital market.

Reducing the period earmarked for sales in terms of capital gains (currently standing at 20 years) for profits made in the capital market, along with regulating the taxation of dividends, would improve the investors' flexibility and response rate. It would also allow greater returns, which, together with a greater volume of transactions, would ensure a more stable tax source for the state. It makes sense to reduce the unreasonably high rate (40 per cent) on structured financial products and derivatives. This form of taxation stifles the development of instruments that could provide investors with an additional choice between potential returns and risks. Further, lowering the rate of corporate income tax for companies that balance and achieve the long-term sustainability of their capital structure through the capital market would increase the volume and sustainability of this source of tax.

3. MEASURES AND ACTIVITIES STIMULATING SUPPLY

3.1. Promoting a balanced capital structure of Slovene companies

Companies will weigh their options amongst three choices in financing their development through the capital market. Drawing funds through bond issues is the first option, which could be an alternative to bank loans in case of a credit crunch and deterioration of terms of credit. The second option is a capital increase on the capital market, the issuing of new stocks. In this case, portfolio investors bear part of the risk in relation to future performance and success of the issuer's development projects. The third option is to find a strategic investor who would enter into the company's ownership structure through the purchase of a minority or majority equity share. Considering the tight liquidity situation on the Slovene market, the possibility of domestic capital connections, apart from companies who already share equity capital, is relatively small. In principle, there is a much greater possibility of acquiring strategic equity alliances abroad through direct foreign investments. However, the aversion to foreign capital and the wish of the existing business owners and management to retain a controlling equity position makes this scenario relatively unlikely. From this perspective, it seems most likely that companies with limited funds will finance their development mainly by issuing bonds and holding IPOs for portfolio investors.

3.2. Ownership dispersed among portfolio investors

Selling blocks to diverse investors through the regulated market

In the past, the state in connection with other major shareholders has favoured the sales of entire controlling stakes. The main reason for this type of sale is the price. Selling a controlling stake usually allows generating maximum returns, while the buyer of the controlling stake also assumes a major part of the Slovene market.

This can cause a high level of risk in certain sectors (banking, telecommunications, etc.), as the buyer thus gains an important influence over the Slovene economy.

On the other hand, the state or another major owner could sell off their stakes through public tenders on the regulated market. These could feature all investors, whereby the seller (the state) could limit the minimum and maximum price and number of stocks that a respective investor can purchase. Such a procedure guarantees transparency, as all investors can purchase stock under the same terms, whereby their competition is limited only to the tendered price, which also means maximum returns for the seller.

An important reason in favour of holding IPOs of state-owned stakes through tenders is that they would thus set up the concept and system that small and large businesses could then use to issue new stocks and sell them off to investors. This would allow companies to finance their development through the issuing and sale of stocks to private investors in a cost-efficient manner.

Capital increases through rights issue to existing shareholders

A recognised and established practice in capital increases abroad includes rights issues to existing shareholders. Generally, rights are only traded on a stock exchange for a brief period prior to the exchange of rights for new stocks and their listing on the regulated market. This ensures a fairer price and improves the infrastructure for the exchange of rights for new stocks. Slovenia has yet to see this type of capital increases, which is why we need to define an efficient procedure for it, using the existing infrastructure. Capital increases through rights issues would foster:

- rights issues and their trading on the market;
- capital increases under current market rates (comparable with foreign markets) while simultaneously protecting the interests of shareholders, where everyone makes their own decisions (paying up new stocks, selling rights);
- the market price of rights determines the real interest for capital increase and therefore the value of newly issued stocks for prospective investors.

3.3. Restructuring the state's investment portfolio

In its role as a major (majority or controlling) owner, the state will find it hard to provide its strategically-held companies with the required capital through capital increases. At the same time, the state has actively prevented these companies from drawing fresh capital on capital markets through its controlling influence, in order to protect its controlling stake. If ever the financial crisis is the time for the state to act as a responsible owner and set the major Slovene companies free in terms of capital and development, and to define its long-term target ownership position. In companies that politics defines as strategic it makes sense for the state to reduce its equity share to a controlling stake. This can be done gradually through capital increases. A suitable formula for such a strategic investment would be “26xy”, where the state retains a 26% (controlling) stake; an x stake is sold to a strategic owner, while stake y is sold to various owners through an IPO.

The strong presence of the state in Slovene companies makes investing into them increasingly unpredictable (sudden changes of management boards, decisions on takeover bids, etc), which drives away investors.

3.4. Setting up a Slovene market for corporate bonds

The international bond market is a viable opportunity for drawing funds, particularly for the state and Slovene financial companies. The other companies, which face limited access to bank loans due to the crisis, have no real alternative, however, if the domestic bond market is not set up. What is important here is also the Slovene banks' securitisation of loans, as the banks which will soon be forced to adjust the scope and structure of their portfolios to higher capital requirements and tightened rules on assuming risk (e.g. covered bonds).

Slovene (non-financial) companies are generally not credit rated by international rating agencies, which reduces the potential foreign investor pool. These investors expect consolidated financial statements under IFRS at least for the past few years, and the conversion of past statements from Slovenian Accounting Standards to IFRS is a time-consuming and financially demanding operation.

3.5. Systematic listing of companies

Listing major companies with a large number of private investors

Over the last few years the state has systematically listed major Slovene companies with mixed ownership on the stock exchange (bank NKBM, telecommunications operator Telekom Slovenije, insurer Zavarovalnica Triglav, reinsurer Pozavarovalnica Sava). This has provided minority shareholders with better information regarding company performance, and especially with an opportunity to sell at the market price. Management boards are now more directly exposed to assessments by financial analysts and investors, which also limits majority owners in asserting their private interests. However, through KAD and SOD, and either directly or indirectly, the state still controls quite a number of joint-stock companies that have a large number of private investors who hold considerable equity but have relatively limited corporate rights. These companies would certainly be suitable for listing, particularly if the state is no longer able to guarantee enough capital for their development.

Listing new private companies

If Slovenia wants to keep pace with the rate of development of the older EU member states, a developed capital market will have to become an important driver pushing the Slovene economy, since the banking system is bound to be much more limited in financing projects in the future. In order to achieve this, it is necessary to create as many initiatives as possible to allow young, fast-growing companies to list on the stock market. Without fresh issues we cannot expect real growth. Companies listed on the stock exchange could be subject to a lower tax rate (for instance, such companies could be exempt from tax on profits for 5 years following listing on the stock exchange). Such a solution would have practically no negative impacts on the budget, while it could potentially persuade many private companies to list instead of selling their stocks to foreign competitors. This will allow Slovene citizens to become part of their growth – either directly or through investment into pension and mutual funds. In order to increase economic growth, it is necessary to help domestic innovators, allow them to start up new companies and list them on the stock exchange at a certain stage, also by stimulating new types of investment, such as venture capital funds.

Listing financial companies pursuant to Basel principles

The amended Basel standards for banks speak of market discipline as the third pillar of control over banks. It is a simple idea, namely that the capital market is among the first to sense that a certain financial institution is in trouble. This happened and was underlined by the last financial crisis, when regulators only reacted after the capital market had sent a clear message about the most troubled institutions. In Slovenia we lack this type of warning system, as banks are mostly owned by the state, domestic companies and foreigners, while only two banks are listed on the stock exchange. An interesting example is the Czech Republic, where even banks under predominant foreign ownership are at least partially listed. This establishes a system of market discipline, while also opening interesting investment opportunities for financial investors.