

Pursuant to Article 161, paragraph (1), item 4 of the Credit Institutions Act (Official Gazette 117/2008) and Article 43, paragraph (2), item (9) of the Act on the Croatian National Bank (Official Gazette 75/2008), the Governor of the Croatian National Bank hereby issues the

**DECISION
ON THE CLASSIFICATION OF PLACEMENTS AND OFF-BALANCE
SHEET LIABILITIES OF CREDIT INSTITUTIONS**

1 GENERAL PROVISIONS

**Subject matter
Article 1**

This Decision prescribes:

- 1) the criteria for the classification of placements and off-balance sheet liabilities on the basis of which a credit institution is exposed to credit risk,
- 2) the method of determining losses arising from credit risk,
- 3) the method of determining value adjustments, impairment of on-balance sheet items and provisions for off-balance sheet items,
- 4) rating of instruments of collateral for receivables, and
- 5) keeping of credit records.

**Legal persons subject to the application of the Decision
Article 2**

- (1) Credit institutions with registered offices in the Republic of Croatia, authorised by the Croatian National Bank, with the exception of electronic money institutions, shall be obliged to apply the provisions of this Decision.
- (2) Branches of credit institutions from third countries, authorised by the Croatian National Bank to provide services, shall also be obliged to apply the provisions of this Decision *mutatis mutandis*.

**Definitions
Article 3**

The individual terms used in this Decision shall have the following meaning:

- 1) '**Placements**' mean financial assets in a form of granted loans, debt instruments and other receivables, classified by a credit institution into categories

of financial instruments, in accordance with its business policies, which are, according to the International Accounting Standard 39 Financial Instruments: Recognition and Measurement (hereinafter: IAS 39), designated as

- "loans and receivables" and
- "held-to-maturity investments"

In addition to principal, placements shall also encompass interest accounted for at nominal interest rate and all commissions and fees, i.e. interest income, in entirety, relating to an individual financial instrument.

2) '**Individually significant exposure**' means the overall exposure of a credit institution to a single person or to a group of connected persons, which does not exceed the amount determined by Article 9 of this Decision. For the purpose of this Decision, the exposure amount includes all on-balance and off-balance sheet asset items that are subject to classification into risk categories in accordance with the provisions of this Decision, including the exposures that are not subject to a restriction, pursuant to the Decision on large exposures of credit institutions.

3) '**Portfolio of small loans**' means the overall exposure of a credit institution to a single person or to a group of connected persons (on the basis of all the exposures referred to in item (2) of this Article) which does not exceed the amount determined by Article 9 of this Decision.

4) '**Individual credit risk assessment**' means an individual assessment of future cash flows and determining the existence or non-existence of losses on each individual placement and individual off-balance sheet liability, which a credit institution is obliged to apply when assessing placements and off-balance sheet liabilities constituting an integral part of individually significant exposure, i.e. which a credit institution may also apply when assessing exposures from the portfolio of small loans.

5) '**Collective credit risk assessment**' means a collective assessment of future cash flows and determining the existence or non-existence of losses on several similar placements, i.e. off-balance sheet liabilities, which is performed in the following cases:

- when assessing quality of placements, i.e. off-balance sheet liabilities, where no evidence is identified of the existence of evident losses, but where latent losses may exist, which are collectively assessed on the basis of historical loss experience (this assessment includes all placements, i.e. off-balance sheet liabilities, classified into risk category A), and
- when assessing identified losses on placements classified under "portfolio of small loans", unless these placements are assessed individually.

6) '**Value adjustment of placements**' means the amount of identified losses on placements for which evidence of impairment loss exists (placements classified into risk category B-1 and worse), as well as the amount of loss on placements for which there is no evidence of impairment loss when assessed individually, but for which an assessment has been made, on the basis of historical loss

experience, that latent losses exist in the portfolio of placements classified into risk category A.

7) '**Assumed off-balance sheet liabilities**' mean traditional off-balance sheet risky items, i.e. liabilities (which do not include the contractual value of derivative instruments), the settling of which requires or might require an outflow of credit institution's cash, on the basis of which, due to uncollectibility of the future outflow of credit institution's funds, the credit institution is exposed to credit risk (issued guarantees, opened uncovered letters of credit, letters of guarantee, commitments under credit contracts, etc.).

8) '**Provision for off-balance sheet liabilities**' means the amount of assessed losses due to uncollectibility of the future outflow of credit institution's funds, for the purpose of settling the assumed off-balance sheet liabilities.

2 CLASSIFICATION OF PLACEMENTS INTO RISK CATEGORIES

2.1 SUBJECT OF CLASSIFICATION

Placements classified into risk categories

Article 4

(1) A credit institution shall classify placements, which are in accordance with IAS 39 classified into the following categories, into the appropriate risk categories by a degree of credit risk:

- 1) loan and receivables, and
- 2) held-to-maturity investments.

(2) Placements referred to in paragraph (1) of this Article shall include all balance sheet assets items on the basis of which a credit institution is exposed to a credit risk and which may be allocated to an individual debtor, as follows:

- 1) loans granted by a credit institution, including receivables arising from any payments made under uncovered letters of credit, guarantees and other commitments,
- 2) deposits with credit institutions, including deposits with the Croatian National Bank,
- 3) receivables based on financial leasing and factoring and forfeiting,
- 4) investments in debt securities,
- 5) receivables based on interest and non-interest income,
- 6) advance payments, and
- 7) other receivables on the basis of which a credit institution may be exposed to a credit risk due to a counterparty's default.

(3) Placements subject to the application of this Decision shall not include financial assets classified by a credit institution into the following categories, in accordance with IAS 39:

- 1) financial assets at fair value through profit or loss, and

- 2) available-for-sale financial assets.

2.2 CRITERIA FOR PLACEMENT CLASSIFICATION ACCORDING TO A DEGREE OF CREDIT RISK

General classification criteria

Article 5

(1) A credit institution shall, in the entire period of contractual relationship, assess placement quality and shall classify placements into the appropriate risk categories on the basis of the following criteria:

- 1) debtors' creditworthiness,
- 2) debtors' timeliness in meeting their obligations towards a credit institution and other creditors, and
- 3) quality of instruments of collateral for credit institution's receivables.

(2) In accordance with best practice for credit risk management, a credit institution shall take into account, in classification placements, all the three criteria referred to in paragraph (1) of this Article.

(3) Notwithstanding paragraph (2) of this Article, a credit institution may base its classification, i.e. placement quality assessment, on only one criterion or two criteria, referred to in paragraph (1) of this Article, as follows:

- in placements constituting an integral part of exposure to a single person, which does not exceed the amounts referred to in Article 9 of this Decision, under the condition that identified losses on these placements are collectively assessed, or
- in placements constituting an integral part of exposure to a single person, which exceeds the amounts referred to in Article 9 of this Decision, under the condition referred to in paragraph (4) of this Article.

(4) Provided that a credit portfolio of a credit institution also contains placements in the approval of which borrower's creditworthiness was not the main criterion, but rather quality and value of collateral, a credit institution shall, in the period of credit relationship, assess quality of these placements on the basis of the results of monitoring the value and liquidity of the respective instrument of collateral.

Debtors' creditworthiness

Article 6

(1) A credit institution shall assess debtors' creditworthiness at least on the basis of the following criteria:

- 1) debtor's status, personal and economic characteristics, as well as expertise of management and senior management (for legal persons), quality of plans and programmes financially supported by a credit institution,

- 2) debtor's level of capital and reserves and their share in debtor's balance sheet (for legal persons),
- 3) debtor's asset strength,
- 4) debtor's liquidity and profitability (for legal persons),
- 5) debtor's cash flows in the previous period and the expected future cash flows, relative to his/her liabilities
- 6) business conditions and future prospects of a debtor, as well as debtor's position on the market and the position of the entire industry in which a debtor is engaged, and
- 7) debtor's exposure to currency risk arising from placements indexed to foreign currency and placements denominated in foreign currency, including off-balance sheet liabilities indexed to foreign currency and off-balance sheet liabilities denominated in foreign currency.

(2) Credit risk arising from placements referred to in paragraph (1), item (7) of this Article and the risk management techniques shall be viewed by the credit institution from the aspect of a possible change of the debtor's financial position which could take place due to a change in the exchange rate of the domestic currency against foreign currencies, i.e. from the aspect of debtors' ability to meet their credit liabilities towards a credit institution, in accordance with the contract, even in potentially changed circumstances.

(3) For the purpose of paragraph (2) of this Article, a credit institution shall establish an internal system of monitoring, analysing and assessing whether the foreign exchange position of an individual debtor or peer groups of debtors is matched and whether their cash flows can be adjusted to the potential changes in the level of their liabilities towards a credit institution and overall liabilities due to the effect of changes in the exchange rate. A credit institution shall award a particular attention to debtors with a mismatched position (with a short foreign exchange position), as a result of which, in the case of a change in the exchange rate of the domestic currency against foreign currencies (including off-balance sheet liabilities), major disturbances could occur in settling liabilities of these debtors towards a credit institution. It shall be deemed that the foreign exchange position of a credit institution's debtors is not matched if their foreign exchange inflow covers less than 80 percent of their foreign exchange liabilities and liabilities indexed to foreign currency, which they have towards the credit institution and other creditors. A bank shall develop an internal system of identifying debtors with matched and mismatched foreign exchange position.

(4) Exceptionally, paragraphs (2) and (3) of this Article shall not apply to placements indexed to foreign currency and foreign exchange placements which include off-balance sheet liabilities denominated in foreign currency, provided that the overall exposure, on the basis of this paragraph, to a single natural person and to a single legal person does not exceed HRK 50 000 and HRK 500 000, respectively.

Timeliness in meeting obligations

Article 7

(1) Debtors' timeliness in meeting their obligations shall imply their capability to fully meet their obligations to a credit institution on the basis of principal, interest, commissions, and on another basis, in the contractual amounts and within the contractual time limits and only exceptionally and occasionally, after the due date, on the condition that the debtor's default is no more than 90 days and that the amount of debt in default is not material, i.e. that it does not exceed the amount referred to in Article 18, paragraph (4) of this Decision.

(2) For the purpose of paragraph (1) of this Article, it shall not be deemed that debtors' timeliness in meeting their obligations exist in the following cases:

- 1) if a credit institution grants a new placement in exchange for the existing one (refinancing), or
- 2) if a credit institution considerably changes the originally contracted terms of crediting, in terms of debt amount and repayment period, due to a debtor's deteriorated financial position (loan restructuring).

(3) Notwithstanding paragraph (2), item (1) of this Article, a credit institution shall not be obliged to treat refinancing as debtor's delinquency in meeting obligations, if it has been established by the analysis of the debtor's financial position that refinancing is not caused by his/her deteriorated financial position, but rather by the usual current needs for financing of his/her business activity.

Collateral quality

Article 8

For the purpose of this Decision, eligible instruments of collateral for receivables shall be those instruments meeting the conditions referred to in Articles 36, 37 or 38 of this Decision.

2.3 INDIVIDUALLY SIGNIFICANT EXPOSURE

Individually significant exposure

Article 9

(1) Individually significant exposure shall be the overall exposure of a credit institution to a single person or to a group of connected persons, exceeding the following amounts:

- 1) HRK 500 000 if total assets of a credit institution amount to less than HRK 5bn,
- 2) HRK 1 000 000 if total assets of a credit institution amount from HRK 5 to 20bn, or
- 3) HRK 1 500 000 if total assets of a credit institution amount to more than HRK 20bn.

(2) The exposure referred to in paragraph (1) of this Article shall include the total amount of all on-balance sheet and off-balance sheet assets items, classified into risk categories, in accordance with the provisions of this Decision (including the exposures which are not subject to a restriction under the Decision on large exposures of credit institutions) and which are reported in gross amount, i.e. without impairments of balance sheet assets items and provisions for off-balance sheet items.

(3) The assets referred to in paragraph (1) of this Article shall be the assets amount reported in audited financial reports of a credit institution for the previous year.

(4) Notwithstanding paragraph (1) of this Article, a credit institution may determine, by its internal by-law, a smaller amount of overall exposure to a single person as a threshold above which an exposure is considered individually significant.

(5) A credit institution shall apply the criteria determined by paragraphs (1) or (4) of this Article consistently to all its debtors.

Credit risk assessment for individually significant exposure

Article 10

(1) A credit institution shall assess individually credit risk, i.e. losses on placements to debtors who are persons or groups of connected persons to whom overall credit exposure of a credit institution exceeds the amounts referred to in Article 9 of this Decision.

(2) An individual assessment of credit risk, i.e. loss, shall imply the assessment of future cash flows and identification of existence or non-existence of losses for each placement that is a part of individually significant exposure.

2.4 EXPOSURE THAT IS NOT INDIVIDUALLY SIGNIFICANT

Portfolio of small loans

Article 11

For the purpose of this Decision, exposure of a credit institution to a single person or to a group of connected persons shall not be considered individually significant if it does not exceed the amounts referred to in Article 9 of this Decision (portfolio of small loans).

Assessment of credit risk for portfolio of small loans

Article 12

(1) A credit institution shall assess individually credit risk, i.e. losses on placements constituting an integral part of portfolio of small loans, for each placement or for several placements that belong to that portfolio.

(2) Provided that credit risk, i.e. losses on placements constituting a portfolio of small loans, are assessed individually, a credit institution shall act in a manner referred to in Article 10, paragraph (2) of this Decision.

(3) Provided that a credit institution assesses credit risk, i.e. losses on placements constituting a portfolio of small loans, for several placements together, it shall perform the assessment of future cash flows and identification of existence and non-existence of losses together for several placements with similar characteristics (it shall form several peer groups within the portfolio of small loans).

2.5 PLACEMENTS ACCORDING TO A DEGREE OF RISK (RISK CATEGORIES)

General classification of placements by credit quality

Article 13

(1) Depending on a possibility of collection, i.e. on the expected future cash flows, all the placements are classified into three broad categories (regardless of whether exposures are individually significant or they belong to a portfolio of small loans), as follows:

- 1) placements for which no evidence of impairment is identified on individual basis (risk category A),
- 2) placements for which evidence of partial impairment is identified, i.e. partly recoverable placements (risk categories B-1/B-2/B-3), and
- 3) placements for which evidence of impairment is identified, equal to their carrying amount, i.e. fully irrecoverable placements (risk category C)

(2) A credit institution shall perform assessment of credit risk and future cash flows or identification of existence or non-existence of losses on placements, referred to in paragraph (1) of this Article, in accordance with the provisions of Articles 14 to 24 of this Decision.

2.5.1 PLACEMENTS FOR WHICH NO OBJECTIVE EVIDENCE OF IMPAIRMENT IS IDENTIFIED (RISK CATEGORY A)

Criteria for classification into risk category A

Article 14

(1) A credit institution shall initially, at the beginning of a contractual relationship, classify the granted placements into risk category A.

(2) Placements shall be classified into risk category A, if all of the following conditions are met:

- 1) present financial position of a debtor and the estimated future cash flows do not threaten his future operation and settling of current and future liabilities towards a credit institution and other creditors,

- 2) debtor settles his liabilities towards a credit institution within the contractual time limits, and only exceptionally and occasionally, after the due date, and
 - 3) placements are secured by eligible instruments of collateral for receivables of a credit institution, referred to in Article 36 to 38 of this Decision.
- (3) Notwithstanding paragraph (2) of this Article, a credit institution may classify an individual placement into risk category A only on the basis of one criterion or two criteria referred to in paragraph (2) of this Article, if it has assessed, based on the available documentation, that collection of placements will be made in the contractual amount.

**Subsequent individual assessment of placements classified into
risk category A
Article 15**

- (1) During the period of contractual relationship, a credit institution shall perform on a regular basis, and at least every three months, subsequent assessment of the quality of placements that were initially, at the beginning of the contractual relationship, classified into risk category A. If it has been established by the subsequent assessment that future cash flows will not be sufficient for settling the contractual amount of individual placements, regardless of whether these placements constitute an integral part of individually significant exposure or they belong to a portfolio of small loans, a credit institution shall reclassify these placements into category of partly recoverable or fully irrecoverable placements (into risk category B-1 or worse).
- (2) Subsequent assessment of the quality of placements constituting an integral part of individually significant exposure shall be performed by a credit institution in accordance with Article 10 of this Decision, and subsequent assessment of the quality of placements constituting a portfolio of small loans, in accordance with Article 12 of this Decision.
- (3) Placements graded A, for which no evidence of impairment is identified at subsequent assessment, i.e. for which it is established, on the basis of the assessment of the future cash flows, that no impairment on individual basis is required, regardless of whether these placements constitute an integral part of individually significant exposure or they belong to a portfolio of small loans, shall remain in the risk category A until the following assessment. Placements of this category shall be collectively assessed by a credit institution for credit risk and for impairment, in accordance with Articles 16 and 17 of this Decision.
- (4) Notwithstanding paragraph (3) of this Article, in the event of a debtor's delinquency, the assessment of the future cash flows shall be based on the value of collateral, and, if a credit institution fails to take the required legal actions for the collection of its receivables by realising the collateral, it shall reclassify the placements that were previously graded A into risk category B-1 or worse and shall make the appropriate value adjustment. Delinquency is considered to have occurred if a debtor has overdue liabilities towards a credit institution, which are

considered materially significant, for more than 90 days, in accordance with Article 18, paragraph (4) of this Decision.

(5) If a credit institution has taken legal actions for the collection of receivables by realising instruments of collateral, and the collection was not completed within two years, counting from the date of initiating legal actions for collection, its shall reclassify the respective placements into risk category B-1 or worse and, taking into account the remaining possibility of collection, make value adjustment of at least 30% of the carrying amount of these placements.

(6) The provisions of paragraphs (4) and (5) of this Article shall also relate to placements constituting an integral part of individually significant exposure and to those that belong to a portfolio of small loans, when assessed individually.

Subsequent collective assessment of placements classified into risk category A

Article 16

(1) For the purpose of a collective assessment of credit risk and collective impairment of placements, a credit institution shall classify placements graded A into appropriate categories which correspond to the balance sheet positions where the balance of these placements is reported.

(2) Within categories referred to in paragraph (1) of this Article, placements are further grouped by similar credit risk characteristics. This classification may be performed according to the purpose of placement, economic activity, geographic area, institutional sector of a debtor (corporates, credit institutions, financial institutions, government, households), type of collateral, risk weights that are assigned to individual placements in accordance with the Decision on capital adequacy of credit institutions.

(3) Losses that are collectively assessed shall imply losses for which there is no evidence on the basis of which a direct relation could be made to individual placements constituting an integral part of individually significant exposure, i.e. to a peer group of placements constituting a portfolio of small loans, but for which it may be assessed, on the basis of historical loss experience, that they exist as latent losses in credit portfolio.

(4) A credit institution may consider the following as the data indicating that unfavourable changes have occurred in the course of contractual relationship which may contribute to a reduction of the future cash flows of a certain category of placements that may be measured, although they cannot be directly related to individual placements:

- 1) changes as regards payment ability of a debtor within an individual group (e.g. increased number of delayed payments, increased number of debtors settling their liabilities by a credit card or those who have reached their credit limit and are repaying only the minimum monthly amount), and
- 2) economic conditions, at the government or local level, related to a failure of a certain group of debtors to settle their liabilities (e.g. increased

unemployment rate in a geographic area of a debtor, fall in prices of real estates provided as collateral or those on which there is fiduciary transfer of ownership and other unfavourable changes affecting the payment ability of a debtor).

(5) A credit institution shall perform a collective assessment of impairment losses on placements graded A in accordance with Article 17 of this Decision, taking into account the provisions of IAS 39, relating to impairment losses and uncollectibility of financial assets carried at amortised cost.

Collective impairment of placements classified into risk category A

Article 17

(1) It is considered that the future cash flows arising from placements graded A, assigned a risk weight of 0% in accordance with the Decision on capital adequacy of credit institutions, shall cover the contractual amount (principal and interest) and that collective impairment of this category of placements is not required, except when, due to exceptional circumstances, a credit institution has assessed that collective impairment for these placements is justified.

(2) It is considered that in a portfolio of placements classified into risk category A, which are assigned a risk weight greater than 0% by a credit institution, in accordance with the Decision on capital adequacy of credit institutions, there are latent losses that could not have been identified as losses related to individual placements (regardless of wheatear these placements constitute an integral part of individually significant exposure or they belong to a portfolio of small loans). The credit institution shall perform collective impairment of these placements.

(3) Collective impairment of placements in the cases when exceptional circumstances have occurred, referred to in paragraph (1), and impairment referred to in paragraph (2) of this Article shall be performed in the amount of latent losses established by a credit institution by the application of its internal methodology, prepared and tested in advance, based on its historical loss experience.

(4) Until the beginning of application of the internal methodology for the assessment of latent losses arising from a portfolio of placements graded A, a credit institution shall maintain the level of impairment (value adjustment) of these placements equal to the amount that is not below 1% of the base referred to in paragraph (5) of this Article. If the amount of impairment (value adjustment) of placements graded A, on the date of entry into force of this Decision, or during the period before the beginning of application of the internal assessment methodology, referred to in paragraph (3) of this Article, falls below 1% of the base, referred to in paragraph (5) of this Article, a credit institution shall increase the impairment (value adjustment) of these placements up to the amount that is not below 1% of that base.

(5) The calculation base for impairment of placements, referred to in paragraph (2) of this Article, shall consist of the carrying amount of placements classified

into risk category A, reduced by the value of placements assigned a risk weight of 0%, in accordance with the Decision on capital adequacy of credit institutions.

(6) Impairment (value adjustment) of placements graded A shall be accounted for by debiting expenses of a credit institution for the period when the losses are identified and by crediting the corresponding value adjustment accounts of placements that are subject to the classification under this Decision.

(7) A credit institution shall re-examine its internal methodology for risk assessment, at least once a year, and shall revise it as appropriately, for the purpose of reducing the differences between the estimated and actual latent losses that exist in the credit portfolio of a risk category A.

2.5.2 PARTLY RECOVERABLE PLACEMENTS (RISK CATEGORIES B-1/B-2/B-3)

Evidence of existence of losses and impairment of placements

Article 18

(1) Evidence of existence of losses arising from credit risk shall imply data on one or more past events adversely affecting the debtor's ability to settle its liabilities towards a credit institution and other creditors in a timely manner. These events have occurred between the date of initial recognition of a placement and the date of subsequent assessment of the future cash flows arising from these placements. A credit institution shall account for losses as a result of past events by debiting expenses of the current period. Losses expected as a result of future events, no matter how likely, shall not be recognised as an expense of impairment of placements in the current period. A credit institution may form the appropriate reserves for covering these losses by distributing profit of the current period.

(2) Evidence of loss, in terms of paragraph (1) of this Article, relating to placements constituting individually significant exposures or a peer group of placements that belong to a portfolio of small loans, shall include in particular:

- 1) observable significant financial difficulties of a debtor,
- 2) a breach of contract, such as a default or delinquency in interest and/or principal payments or failure to perform other provisions of the contract,
- 3) restructuring of placements caused by debtor's financial difficulties, which results in a reduction of the originally contracted liabilities of a debtor, and
- 4) existence of a probability of initiation of bankruptcy proceedings or taking of another legal action (financial reorganisation) as a result of a debtor's poor financial position.

(3) It is considered that there is evidence of loss, referred to in paragraph (2), items (1) and (2) of this Article, on the basis of which a credit institution is obliged to reclassify placements graded A, which are not secured by eligible instruments of collateral referred to in Article 8 of this Decision, into a worse

risk category, if a debtor has overdue liabilities towards a credit institution as follows:

- 1) into risk category B-1, if a debtor has overdue liabilities from more than 90 to 180 days,
- 2) into risk category B-2, if a debtor has overdue liabilities from more than 180 to 270 days,
- 3) into risk category B-3, if a debtor has overdue liabilities from more than 270 to 365 days, or
- 4) into risk category C, if a debtor has overdue liabilities for more than 365 days.

(4) In the case referred to in paragraph (3) of this Article, counting the days of delinquency starts with the day when the total amount of debtor's all overdue liabilities (where the contractual maturity date has expired) based on all contractual relationships has become materially significant, i.e. larger than HRK 1 750.

(5) A credit institution shall classify into risk category C any unsecured placement where a continuous delinquency of a debtor in settling liabilities towards a credit institution lasts for more than 365 days, counting from the maturity date, and the overdue amount is not materially significant, i.e. it is below HRK 1 750.

(6) Exceptionally, paragraph (3) of this Article shall not apply to:

- 1) placements constituting an integral part of individually significant exposure, if it is assessed that debtor's delinquency in settling liabilities is temporary, i.e. if it can be assessed with certainty, on the basis of the criteria referred to in Article 5 of this Decision, that individual placements are fully recoverable, and
- 2) partly recoverable placements constituting an integral part of individually significant exposure, where it is assessed, on the basis of the estimated future cash flows, that larger or smaller loss exists compared to the one that would be determined based on days of delinquency in settling liabilities, referred to in paragraph (3) of this Article. Such a placement is classified into a corresponding risk category in accordance with Article 19 of this Decision.

(7) Classification of placements referred to in paragraph (3) of this Article (on the basis of days of delinquency in settling of debtor's liabilities) into an appropriate risk category requires the corresponding impairment, i.e. value adjustment of these placements in accordance with Article 19 of this Decision.

Partly recoverable placements

Article 19

(1) Partly recoverable placements shall be those placements, for which, due to a debtor's deteriorated creditworthiness, delinquency in settling liabilities towards a credit institution and reduced value of eligible instruments of collateral, it is assessed that principal and interest could not be collected in the contractual

amount. Those are the placements for which evidence exists that present value of the expected future cash flows arising from these placements is lower than their carrying amount.

(2) A credit institution shall classify partly recoverable placements, according to the amount of identified loss, into the following risk categories:

- 1) into risk category B-1 (placements for which the identified loss does not exceed 30% of the carrying amount of an individual placement),
- 2) into risk category B-2 (placements for which the identified loss is between more than 30% and 70% of the carrying amount of an individual placement), and
- 3) into risk category B-3 (placements for which the identified loss is between more than 70% and less than 100% of the carrying amount of an individual placement).

(3) The loss referred to in paragraph (2) of this Article results from a difference between the carrying amount of an individual placement and present value of the expected future cash flows, discounted by applying the effective interest rate referred to in Article 20 of this Decision.

(4) Notwithstanding the provision of paragraph (3) of this Article, if the period within which future cash flows from an individual placement are expected is shorter than one year, counting from the balance sheet date, a credit institution shall not be obliged to calculate the present (discounted) value of the expected future cash flows. In that case, a credit institution may determine the loss as the difference between the carrying amount of the placement and the expected future cash flows arising from that placement.

(5) The amount of loss from partly recoverable placements shall be calculated by a credit institution individually for each placement that is a part of individually significant exposure, the carrying amount of which exceeds the amount referred to in Article 9 of this Decision.

(6) Notwithstanding the provision of paragraph (5) of this Article, losses arising from placements may be assessed for several placements together, as follows:

- 1) for placements under portfolio of small loans, referred to in Article 11 of this Decision, which have similar characteristics with respect to purpose, maturity, interest rate, instruments of collateral, etc., and
- 2) for all placements to a single debtor against whom bankruptcy proceedings have been initiated, apart from receivables from a bankruptcy debtor where a credit institution is a creditor, for which a recoverable amount or impairment loss are assessed individually.

Effective interest rate

Article 20

(1) For the purpose of discounting the expected future cash flows arising from partly recoverable placements, a credit institution shall apply as the initial (original) effective interest rate the annual percentage rate (APR), which is computed at the conclusion of the credit contract, in accordance with the methodology set out in the Decision on the Uniform Disclosure of the Effective Interest Rate on Loans and Deposits. The annual percentage rate (APR) is the rate which does not include the effect of security deposit flows in calculating the effective interest rate. If, in the case of financial difficulties of a debtor, the lending terms and conditions, concerning the level and time limits for repayment, are modified by a subsequent annex to the contract, the initial rate (APR), which was determined prior to the modification of the contract, shall be used for discounting the expected future cash flows arising from these placements.

(2) For discounting the expected future cash flows arising from partly recoverable placements, where the initial contract contains the interest rate variability clause or where the originally contracted interest rate was changed by a subsequent annex to the contract, a credit institution shall apply the current/present effective interest rate. The application of the current/present effective interest rate shall imply the application of the annual percentage rate (APR) computed at the time of determining the present value of the expected future cash flows arising from partly recoverable placements. A credit institution shall compute this rate (APR) by taking into account the entire period for which the contract was concluded (rather than only the remaining maturity) and the interest rate applicable as at the date of computation. Accordingly, the APR is computed under the assumption that a placement was initially contracted at the currently applicable, i.e. modified interest rate.

(3) When the present value of the expected future cash flows for partly recoverable placements is determined for the placements which were not subject to effective interest rate computation at the time of approval, a credit institution shall calculate the annual percentage rate (APR) for the purpose of discounting the future cash flows, on the basis of the initial contractual provisions, applying the fixed or current/present interest rate in accordance with paragraphs (1) and (2) of this Article.

Accounting for impairment of placements

Article 21

(1) Impairment of placements classified into risk category B-1/B-2/B-3 (in the amount of identified loss, in accordance with paragraphs (3) and (4), Article 19 of this Decision) shall be recognised by a credit institution in profit or loss, by debiting expenses of a credit institution for the period when these losses are

identified and in the balance sheet assets, by crediting the value adjustments account for placements to which these adjustments relate.

(2) Provided that, upon the initial impairment of placements, the loss has increased at a subsequent assessment (which is performed at least once in a quarter) due to altered circumstances affecting the assessment, the amount of increased loss shall be accounted for by the credit institution in accordance with paragraph (1) of this Article.

(3) Provided that the loss, referred to in paragraph (1) of this Article, is reduced, the amount of reduction shall be recognised by the credit institution in profit or loss, by crediting the account where value adjustment expense was previously recognised, and in the balance sheet assets, by debiting the value adjustments account for placements to which these adjustments relate.

2.5.3 RECOGNITION OF INTEREST INCOME FROM PARTLY RECOVERABLE PLACEMENTS

Recognition of interest income from partly recoverable placements

Article 22

(1) It is deemed that there is uncertainty as regards the collection of interest income from partly recoverable placements (placements classified into risk categories B-1/B-2/B-3) and recognition of that income in profit or loss is postponed until its collection. Receivables on the basis of interest income, referred to in this paragraph, shall be recorded in the credit institution's business books in the off-balance sheet accounts.

(2) Notwithstanding paragraph (1) of this Article, a credit institution may recognise interest income calculated on partly recoverable placements (placements classified into risk categories B-1/B-2/B-3) in profit or loss even prior to their collection, provided that there is evidence that that income will be collected in the following accounting period.

(3) If, at the time of reclassification of placements from risk category A into risk category B-1 or worse there are uncollected receivables based on interest income that was recognised, in the previous period, in profit or loss, a credit institution shall perform value adjustment of the uncollected receivables in the amount of the interest income previously recognised in profit or loss. These receivables shall remain in the balance sheet accounts until they are collected or until legal actions are taken concerning the termination of the debtor's liability, in accordance with the credit institution's policies and procedures and the law regulating civil obligations.

2.5.4 FULLY IRRECOVERABLE PLACEMENTS (RISK CATEGORY C)

Fully irrecoverable placements

Article 23

(1) Fully irrecoverable placements shall be credit institution's receivables acquired on disputable legal basis and other receivables for which, due to especially poor material and financial position of a debtor and a lack of any eligible instrument of collateral, no cash flows can be expected for settling debtor's liabilities towards a credit institution.

(2) Placements referred to in paragraph (1) of this Article shall be classified by a credit institution into risk category C, in accordance with this Decision.

Impairment of placements classified into risk category C

Article 24

(1) It is deemed that present value of receivables graded C equals zero and that impairment loss, i.e. value adjustment of these placements amounts to 100% of their carrying amount.

(2) A credit institution shall record the impairment loss, i.e. value adjustment referred to in paragraph (1) of this Article in the business books, in accordance with Article 21 of this Decision.

(3) Placements classified into risk category C and for which a 100%-value adjustment has been performed shall be recorded by the credit institution in the balance sheet accounts until legal actions are taken concerning the termination of debtor's liabilities, in accordance with the credit institution's policies and procedures and the law regulating civil obligations.

3 CLASSIFICATION OF ASSUMED OFF-BALANCE SHEET LIABILITIES INTO RISK CATEGORIES

3.1 SUBJECT OF CLASSIFICATION

Off-balance sheet liabilities classified into risk categories

Article 25

(1) Irrevocably assumed off-balance sheet liabilities, which can be allocated to individual customers, and on the basis of which a credit institution is exposed to credit risk due to uncollectibility of the outflow of funds which may occur or which occurs in settling of the assumed off-balance sheet liabilities, shall be classified into the appropriate risk categories.

(2) Off-balance sheet liabilities, referred to in paragraph (1) of this Article shall be the following:

- 1) issued guarantees,
- 2) opened uncovered letters of credit,
- 3) letters of guarantee and other commitments,
- 4) granted but not used irrevocable credit lines and other similar loans

- 5) concluded but not implemented irrevocable financial leasing, factoring and forfaiting contracts, and
 - 6) other irrevocably assumed off-balance sheet liabilities, for the settling of which outflow of credit institution's funds will occur or might occur, on the basis of which a credit institution is exposed to credit risk.
- (3) If a credit institution makes payment on the basis of the assumed off-balance sheet liability, the initially assumed liability shall no longer be treated as an off-balance sheet item, but shall become a balance sheet category to which the provisions of this Decision apply, relating to placements, i.e. on-balance sheet items.

3.2 CLASSIFICATION CRITERIA

Off-balance sheet liabilities classification criteria

Article 26

- (1) The main criteria for off-balance sheet liabilities classification into risk categories shall be the following:
- 1) creditworthiness of a person to whom a credit institution has assumed a financing liability, i.e. on whose order a credit institution has opened an uncovered letter of credit, issued a guarantee or another commitment, and
 - 2) quality of instrument of collateral for receivables which may occur on the basis of payment of off-balance sheet liability.
- (2) Timeliness in meeting the obligations of a person referred to in paragraph (1) of this Article towards a credit institution in the previous period, if the same person was at the time a credit institution's debtor, may be an additional criterion for classification of off-balance sheet liabilities into risk categories.

3.3 CLASSIFICATION OF OFF-BALANCE SHEET LIABILITIES ACCORDING TO THEIR SIGNIFICANCE

Assessment of loss for individually significant exposure

Article 27

- (1) A credit institution shall assess individually credit risk or provisions for losses arising from off-balance sheet liabilities, constituting an integral part of individually significant exposure, referred to in Article 9 of this Decision.
- (2) Individual assessment of credit risk, referred to in paragraph (1) of this Article, shall imply the procedure involving the assessment of recoverability of the future outflow of funds, separately for each assumed off-balance sheet liability constituting an integral part of significant exposure to a single person, referred to in Article 9 of this Decision.

Assessment of loss for an exposure that is not individually significant

Article 28

(1) A credit institution shall assess individually or collectively credit risk or provisions for losses that may be incurred due to irrecoverability of outflow of its funds for the purpose of paying off-balance sheet liabilities, assumed towards a person or for the account of a person to whom overall exposure of a credit institution does not exceed the amount referred to in Article 9 of this Decision.

(2) Individual assessment of credit risk or provisions for losses, referred to in paragraph (1) of this Article, shall imply the procedure of assessment of recoverability of the future outflow of funds, individually for each off-balance sheet liability that is a part of exposure that is not individually significant.

(3) Notwithstanding paragraph (2) of this Article, a credit institution may apply an alternative procedure for the assessment of credit risk or provisions for losses that may be incurred due to irrecoverability of outflow of funds for the purpose of paying off-balance sheet liabilities which are a part of exposure to a single person, which is not individually significant. The assessment of recoverability of the future outflow of funds may be performed for several similar off-balance sheet liabilities together.

3.4 CLASSIFICATION OF OFF-BALANCE SHEET LIABILITIES INTO RISK CATEGORIES

General classification of off-balance sheet liabilities by a degree of risk

Article 29

(1) With respect to the assessed possibility of recovering the expected outflow of a credit institution for the purpose of settling off-balance sheet liabilities, these liabilities are classified into three broader categories as follows:

- 1) off-balance sheet liabilities for which no outflow of credit institution's funds is expected, or if the outflow occurs, it is expected to be fully recovered (risk category A),
- 2) off-balance sheet liabilities for which outflow of credit institution's funds is expected that will not be fully recoverable (risk category B-1/B-2/B-3), and
- 3) off-balance sheet liabilities for which outflow of credit institution's funds is expected that will be fully irrecoverable (risk category C).

(2) As regards the criteria for off-balance sheet liabilities classification into risk categories, the provisions of Article 5 of this Decision shall apply *mutatis mutandis*.

3.4.1 OFF-BALANCE SHEET LIABILITIES FOR WHICH NO LOSSES ARE IDENTIFIED (RISK CATEGORY A)

Classification of off-balance sheet liabilities into risk category A

Article 30

(1) A credit institution shall initially classify contractual off-balance sheet liabilities into risk category A.

(2) It shall be deemed that conditions for classification of off-balance sheet liabilities into risk category A are fulfilled if, on the basis of the present financial condition and estimated future cash flows of a person to whom a credit institution is exposed to credit risk, it is assessed that there will be no outflow of credit institution's funds for settling of off-balance sheet liabilities or if the outflow does occur, it will be fully recovered.

Subsequent assessment of off-balance sheet liabilities graded A

Article 31

(1) During the period of contractual relationship, a credit institution shall perform on a regular basis, and at least every three months, subsequent assessment of riskiness of off-balance sheet liabilities that were initially, at the beginning of the contractual relationship, classified into risk category A. If it has been established by the subsequent assessment that circumstances have changed, on the basis of which off-balance sheet liabilities were initially classified into risk category A, regardless of whether these off-balance sheet liabilities constitute an integral part of individually significant exposure, a credit institution shall classify these off-balance sheet liabilities into risk category B-1 or worse.

2) Off-balance sheet liabilities graded A, for which no losses are identified at subsequent assessment, i.e. for which it has been established that provisions for losses on individual basis are not required, regardless of whether these off-balance sheet liabilities constitute an integral part of individually significant exposure, shall remain classified into risk category A until further notice. For these off-balance sheet liabilities, a credit institution shall perform collective assessment of credit risk and make collective provisions for losses.

(3) Losses referred to in paragraph (2) of this Article shall imply losses for which there is no evidence on the basis of which a direct relation could be made to an individual liability constituting an integral part of individually significant exposure, i.e. to several similar off-balance sheet liabilities constituting an integral part of exposure that is not individually significant, but for which it may be assessed, on the basis of historical loss experience, that they exist as latent losses related to off-balance sheet liabilities graded A.

(4) Assessment of provisions for losses referred to in paragraph (2) of this Article shall be performed by a credit institution in accordance with Article 32 of this Decision, taking into account the principles of the International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets (hereinafter: IAS 37).

Provisions for off-balance sheet liabilities graded A on collective basis

Article 32

(1) It shall be deemed that for off-balance sheet liabilities assigned a risk weight of 0%, in accordance with the Decision on capital adequacy of credit institutions (regardless of the conversion factor), no provisions for losses on collective basis are required, unless where a credit institution has assessed, in exceptional circumstances, that even for these off-balance sheet liabilities provisions for losses on collective basis should be made.

(2) It shall be deemed that in a part of off-balance sheet liabilities graded A, which are assigned a risk weight greater than 0% (regardless of a conversion factor), there are certain latent losses which result from the assumed off-balance sheet liabilities and which could not be identified at individual assessment (regardless of whether these liabilities constitute an integral part of individually significant exposure).

(3) Provisions for losses in the cases where exceptional circumstances referred to in paragraph (1) have occurred and provisions referred to in paragraph (2) of this Article shall be made in the amount determined by a credit institution, in accordance with its previously prepared and tested internal methodology, for an individual category of similar off-balance sheet liabilities within category A.

(4) Until the beginning of application of the internal methodology for the assessment of latent losses arising from off-balance sheet liabilities graded A, a credit institution shall maintain the level of provisions for these off-balance sheet liabilities in the amount that is not below 1% of the base referred to in paragraph (5) of this Article. If the amount of provisions for off-balance sheet liabilities graded A, on the date of entry into force of this Decision, or during the period before the beginning of application of the internal assessment methodology, referred to in paragraph (3) of this Article, falls below 1% of the base, referred to in paragraph (5) of this Article, a credit institution shall increase these provisions up to the amount that is above 1% of that base.

(5) The calculation base for provisions referred to in paragraph (2) of this Article shall consist of the carrying amount of off-balance sheet liabilities classified into risk category A, reduced by off-balance sheet liabilities from that category, which are assigned a risk weight of 0% (regardless of the conversion factor), in accordance with the Decision on capital adequacy of credit institutions.

(6) The amount of provisions for losses on a collective basis, arising from off-balance sheet liabilities graded A, shall be accounted for by debiting expenses of a credit institution for the period when these losses are identified and by crediting the corresponding provisions accounts in the balance sheet liabilities.

(7) A credit institution shall re-examine its internal methodology for the assessment of credit risk arising from off-balance sheet liabilities, at least once a year, and shall revise it as appropriately, for the purpose of reducing the

differences between the estimated and actual latent losses associated with off-balance sheet liabilities classified into risk category A.

3.4.2 OFF-BALANCE SHEET LIABILITIES FOR WHICH OUTFLOW OF FUNDS IS EXPECTED THAT WILL NOT BE FULLY RECOVERABLE (RISK CATEGORY B-1/B-2/B-3)

Off-balance sheet liabilities with partly recoverable outflow of funds Article 33

(1) Off-balance sheet liabilities, referred to in Article 30 of this Decision, for which it has been established by subsequent assessment that they no longer meet the conditions for classification into risk category A (regardless of whether they constitute an integral part of individually significant exposure) shall be classified into the appropriate category involving a higher degree of credit risk (B-1/B-2/B-3).

(2) Off-balance sheet liabilities assumed towards a person or for the account of a person whose financial position is not satisfactory, i.e. whose financial position has deteriorated after the assumption of an off-balance sheet liability and after the occurrence of the past obligating event, shall be classified into the appropriate risk category referred to in paragraph (1) of this Article. Those are off-balance sheet liabilities for which it is estimated that, for the purpose of their settling, an outflow of credit institution's funds will occur and the assessment of the future cash flows of a person towards whom or for whose account a credit institution has assumed a liability, as well as the quality of eligible instruments of collateral, point to a conclusion that the credit institution will not be able to recover in entirety all to which it is entitled under the contract, on the basis of the expected outflow of funds for the purpose of paying an off-balance sheet liability.

(3) Depending on the amount of the estimated loss due to a lack of possibility to fully recover the expected outflow of funds for the purpose of settling off-balance sheet liabilities, a credit institution shall classify these liabilities into the following three categories:

- 1) into risk category B-1 (off-balance sheet liabilities where the amount of the required provision does not exceed 30% of the carrying amount of the expected outflow for settling the liabilities),
- 2) into risk category B-2 (off-balance sheet liabilities where the required provisions are between more than 30% and 70% of the carrying amount of the expected outflow for settling the liabilities), or
- 3) into risk category B-3 (off-balance sheet liabilities where the required provisions are between more than 70% and less than 100% of the carrying amount of the expected outflow for settling the liabilities).

3.4.3 OFF-BALANCE SHEET LIABILITIES FOR WHICH OUTFLOW OF FUNDS IS EXPECTED THAT WILL BE FULLY IRRECOVERABLE (RISK CATEGORY C).

Off-balance sheet liabilities with fully irrecoverable outflow of funds

Article 34

(1) Off-balance sheet liabilities for which a credit institution has established at a subsequent assessment (regardless of whether they constitute an integral part of individually significant exposure) that an outflow of its funds will occur for settling of these liabilities and that this outflow cannot not be even partly recovered shall be classified by a credit institution into risk category C.

(2) Risk category C encompasses off-balance sheet liabilities assumed towards a persons or for the account of a person whose financial position has significantly deteriorated after the assumption of an off-balance sheet liability, i.e. after the occurrence of the past obligating event, and it is very likely that an outflow of credit institution's funds will occur for settling the off-balance sheet liability, and the assessment of the future cash flows of a person to whom a credit institution is exposed, as well as the quality of eligible instruments of collateral, point to a conclusion that the credit institution, after settling the assumed liability, will not be able to recover anything to which it is entitled under the contract.

3.4.4 PROVISIONS FOR IDENTIFIED LOSSES ON THE BASIS OF OFF-BALANCE SHEET LIABILITIES

Provisions for identified losses

Article 35

(1) Provisions for identified losses for off-balance sheet liabilities referred to in Article 33 and 34 of this Decision shall be determined in the amount reflecting the best estimate, based on the procedures and policies of a credit institution and IAS 37 principles.

(2) The amount of provisions referred to in paragraph (1) of this Article shall be equal to the amount of the expected future expenditures for settling the off-balance sheet liabilities which a credit institution will not be able to recover.

(3) Notwithstanding the provision of paragraph (2) of this Article, where the effect of the time value of money is material, the amount of provisions referred to in paragraph (1) of this Article shall be equal to the discounted value of the expected future irrecoverable outflows required to settle the off-balance sheet liability (present value of irrecoverable future outflows). The amount of the expected outflows is discounted to their present value at every balance sheet date, at the discount rate reflecting the current market value of money.

(4) In terms of paragraph (3) of this Article, the effect of the time value of money shall be deemed to be material, where it is estimated that the outflow of

resources required to settle the off-balance sheet liability will occur within a period exceeding one year, counting from the balance sheet date.

(5) Outflows (which a credit institution will not be able to recover) shall imply the carrying amount of the expected outflows required to settle off-balance sheet liabilities reduced by the amount assessed with certainty as fully recoverable either by the counterparty or by activating the available instrument of collateral.

(6) The amount of provisions for losses arising from off-balance sheet liabilities classified into risk categories B-1/B-2/B-3 and risk category C, shall be accounted for by debiting expenses of a credit institution for the period when these losses are identified and by crediting the corresponding provisions account in the balance sheet liabilities.

4 RATING OF INSTRUMENTS OF COLLATERAL

First-class instruments of collateral

Article 36

(1) Instruments of collateral that may be recognised in placements classification as first-class instruments are the following:

- 1) cash on deposit with, or cash assimilated instruments held by a credit institution,
- 2) debt securities issued by central governments or central banks with a credit assessment by eligible external credit assessment institutions (hereinafter: ECAI) or by an export credit agency, which has been determined by the Croatian National Bank to be associated with a credit quality step 4 or above under the rules for risk weighting of exposures to central governments and central banks, in accordance with the provisions of the Decision on capital adequacy of credit institutions,
- 3) debt securities issued by institutions with a credit assessment by an eligible ECAI, which has been determined by the Croatian National Bank to be associated with a credit quality step 3 or above under the rules for risk weighting of exposures to institutions, in accordance with the provisions of the Decision on capital adequacy of credit institutions,
- 4) debt securities issued by other entities with a credit assessment by an eligible ECAI, which has been determined by the Croatian National Bank to be associated with a credit quality step 3 or above under the rules for risk weighting of exposures to corporates, in accordance with the provisions of the Decision on capital adequacy of credit institutions,
- 5) debt securities with a short-term credit assessment by an eligible ECAI, which has been determined by the Croatian National Bank to be associated with a credit quality step 3 or above under the rules for risk weighting of short term exposures, in accordance with the provisions of the Decision on capital adequacy of credit institutions,
- 6) equities or convertible bonds that are included in a main index,
- 7) gold,

8) guarantees and commitments which are irrevocable and payable upon first demand, issued by the central governments, central banks and export credit agencies, referred to in item (2) of this paragraph, and

9) guarantees and commitments which are irrevocable and payable upon first demand, issued by the credit institutions with a credit assessment determined in accordance with item (3) of this paragraph.

(2) Where a security, referred to in paragraph (2), items from (2) to (5) of this Article, has two credit assessments by eligible ECAIs, the less favourable assessment shall be applied by a credit institution. In cases where a security has more than two credit assessments by eligible ECAIs, a credit institution shall determine the two most favourable assessments and shall apply the less favourable of the two.

(3) In addition to debt securities, referred to in paragraph (1), item (2) of this Article, the first-class instruments of collateral in a form of debt securities issued by central governments or central banks, shall also include the following:

1) debt securities issued by public sector entities, exposures to which are treated as exposures to central governments, in accordance with the provisions of the Decision on capital adequacy of credit institutions, and

2) debt securities issued by multilateral development banks to which a 0% risk weight is assigned, in accordance with the provisions of the Decision on capital adequacy of credit institutions, and

3) debt securities issued by international organisations to which a 0% risk weight is assigned, in accordance with the provisions of the Decision on capital adequacy of credit institutions.

(4) In addition to debt securities referred to in paragraph (1), item (3) of this Article, the first-class instruments of collateral in a form of debt securities shall also include the following:

1) debt securities issued by the units of local and regional self-government, exposures to which are treated as exposures to institutions, in accordance with the provisions of the Decision on capital adequacy of credit institutions,

2) debt securities issued by public sector entities, exposures to which are treated as exposures to institutions, in accordance with the provisions of the Decision on capital adequacy of credit institutions, and

3) debt securities issued by multilateral development banks other than those to which a 0% risk weight is assigned, exposures to which are treated as exposures to institutions, in accordance with the provisions of the Decision of capital adequacy of credit institutions.

(5) For the purpose of this Decision, other instruments equal in quality to the individually listed instruments of collateral, referred to in paragraphs (1), (3) and (4) of this Article, shall also be deemed first-class instruments of collateral for receivables.

**Appropriate instruments of collateral in a form of real-estate and movable
property
Article 37**

(1) Eligible instruments of collateral in a form of real estate or movable property shall be taken into account by a credit institution in classification of placements or assumed off-balance sheet liabilities, if it has at its disposal all the required documentation from which it is evident that the respective real estate or movable property represents an efficient and proper secondary source of collection. Instrument of collateral in a form of real estate or movable property shall be deemed to have these characteristics if a credit institution has been provided with the evidence that there is a market allowing for an expeditious and economically efficient (at an adequate price) liquidation of collateral.

(2) A credit institution shall, in assessing cash flows, take into account that portion of the value of collateral in a form of real estate, which remains after deducting all liabilities secured by the same real estate, which are registered in the land registry with a higher priority rank or after deducting a proportional part of liabilities that have the same priority rank as the receivables of the respective credit institution.

(3) Market price shall be taken as the value of an instrument of collateral in a form of real estate. Provided that there is no active market for an individual type of real estate, i.e. provided that market price is not available, the most recent valuation of the real estate market value executed by an independent valuer shall be taken into account. In that valuation, the independent valuer shall take into account all the costs associated with the sale. A purchase and sale contract, concluded no later than one year before, may be taken into account as an alternative method for determining the real estate value for commercial real estate.

(4) A credit institution shall have the following documents related to the real estate property used as an instrument of collateral for receivables:

- 1) public notary contract on the registration of mortgage or fiduciary transfer of ownership on the respective real estate property,
- 2) court decision concerning the registration of mortgage or fiduciary transfer of ownership on the respective real estate property in the land registry,
- 3) updated land registry certificate, with the registered mortgage or fiduciary transfer of ownership,
- 4) insurance policy for the respective real estate property, with transferability restricted to a credit institution (except where the real estate property is an undeveloped land), and
- 5) valuation executed by an independent valuer or a purchase and sale contract for the respective real estate property.

(5) In the course of contractual relationship, a credit institution shall continuously monitor the value of real estate accepted as collateral for its receivables, at a minimum once every year for commercial real estate and once every three years for residential real estate. More frequent monitoring shall be

carried out by the credit institution where the market is subject to significant changes in conditions. Statistical methods may be used to monitor the value of the property and to identify property that needs revaluation. If a credit institution has established, on the basis of monitoring, that the value of the property may have declined materially relative to general market prices, it shall request from an independent valuer to review the property valuation.

(6) For placements exceeding 5% of the own funds of the credit institution or exceeding HRK 20m, the property valuation shall be reviewed by an independent valuer at least every three years.

(7) In calculating impairment of placements and provisions for losses arising from off-balance sheet liabilities, the credit institution may use a movable property as an alternative instrument of collateral, if the following conditions are met:

- 1) there is a liquid market allowing for an expeditious and economically efficient (at an adequate price) disposal of the collateral,
- 2) market prices for the respective movable property are available,
- 3) operational conditions for executing sales are fulfilled,
- 4) collateral arrangements enable realisation of value of the property within a reasonable timeframe,
- 5) there is a first priority claim over all other creditors,
- 6) a proper control is in place of the value of collateral at a minimum once every year and on a more frequent basis where the market is subject to significant price changes,
- 7) credit contract, i.e. contract on off-balance sheet liability, shall include detailed descriptions of the collateral,
- 8) a credit institution has a list of eligible types of collateral in a form of movable property, and it has determined by its internal by-law processes and procedures concerning the required coverage for an individual type of collateral, including the ratio of value of receivables to collateral,
- 9) the credit institution's credit policies address appropriate collateral requirements relative to the amount of exposure to debtor, the ability to liquidate the collateral readily and the ability to establish objectively a price or market value of the collateral,
- 10) both initial valuation and revaluation of the respective movable property take fully into account any deterioration of the movable property or the effects of the passage of time on the valuation,
- 11) the credit institution has in place the procedures for a legal examination of validity of the lien on the respective movable property, and
- 12) the lien is registered in the registry of liens on movable property at the institution competent for keeping that registry.

Other appropriate instruments of collateral

Article 38

(1) In addition to instruments, referred to in Article 37 of this Decision, debt securities issued by institutions which securities do not have a credit assessment by an eligible ECAI may be recognised by the credit institution as appropriate collateral if they fulfil the following criteria:

- 1) they are listed on a recognised exchange,
- 2) they qualify as senior debt,
- 3) all other rated issues by the issuing institution of the same seniority have a credit assessment by an eligible ECAI which has been determined by the Croatian National Bank to be associated with credit quality step 3 or above under the rules for the risk weighting of exposures to institutions in accordance with the provisions of the Decision on capital adequacy of credit institutions or under the rules for the risk weighting of short term exposures in accordance with the provisions of the Decision on capital adequacy of credit institutions,
- 4) the credit institution has no information to suggest that the issue would justify a credit assessment below that indicated in item (3) of this paragraph, and
- 5) the credit institution can demonstrate that the market liquidity of the instrument is sufficient for these purposes.

(2) Units in investment funds may be recognised by the credit institution as appropriate collateral if both following conditions are satisfied:

- 1) they have a daily public price quote, and
- 2) the investment fund is limited to investing in instruments that are eligible for recognition in accordance with the provisions of Article 36 of this Decision.

(3) The use by an investment fund of derivative instruments to hedge permitted investments, in accordance with paragraph (2), item (2) of that Article, shall not prevent units in that investment fund from being eligible as financial collateral.

(4) Other appropriate instruments of collateral, in addition to those indicated in paragraphs (1) and (2) of this Article, shall encompass insurance policies for credit receivables and life insurance policies with a surrender value and other instruments of collateral equal in quality to the instruments of collateral referred to in paragraphs (1) and (2) of this Article, on the basis of the appropriate evidence.

Ineligible instruments of collateral

Article 39

All other instruments of collateral accepted by the credit institution, which are not encompassed by Articles 36 to 38 of this Decision (e.g. bills of exchange, debtor's statement of enforcement, guarantees of persons without the appropriate creditworthiness or without a credit assessment by an eligible ECAI) shall be deemed, in terms of this Decision, ineligible instruments of collateral,

which the credit institution cannot take into account in assessing the expected cash flows, i.e. for the purpose of impairment of placements or making provisions for losses arising from the assumed off-balance sheet liabilities.

5 KEEPING CREDIT RECORDS

Contents of credit records

Article 40

(1) A credit institution shall provide information and documentation on debtors by a systematic keeping of credit records. Credit records shall provide the basic information about a debtor, his financial status and position and about the nature of the credit relationship.

(2) Credit records shall contain at a minimum:

- 1) basic data on debtors (first and last name, address or company name, registered office, number of employees, ownership structure, management, connection of a debtor with other persons, if a debtor belongs to a group of connected persons in terms of Credit Institutions Act),
 - 2) main debtors and creditors of every debtor to whom credit institution's exposure is individually significant,
 - 3) financial reports of a debtor for the last three years,
 - 4) analysis and assessment of a financial and economic position of a debtor, including internal rating of a debtor,
 - 5) evidence, if any, of impairment of debtor's financial assets, analysis and assessment of debtor's cash flows relative to his liabilities,
 - 6) proposal for the transaction approval and opinion of an expert service and decision of the credit institution's body competent for transaction approval,
 - 7) credit contract,
 - 8) analytical bookkeeping records of on-balance and off-balance sheet items relating to an individual debtor of a credit institution,
 - 9) documentation concerning instrument of collateral,
 - 10) records on court proceedings initiated by a credit institution in order to collect its receivables,
 - 11) records on court proceedings that may be initiated against a credit institution in order to decrease the plaintiff's liabilities towards a credit institution (e.g. to declare enforcement in favour of the credit institution wrongful, etc.), and
 - 12) other documentation that may complement the information on the debtor's financial position.
- (3) A credit institution shall adopt and implement the procedure for keeping credit records and shall appoint persons responsible for completeness and integrity of individual records.

6 REPORTING TO THE CROATIAN NATIONAL BANK

Contents of reports and reporting time limits

Article 41

(1) A credit institution shall report to the Croatian National Bank on the status of placements and off-balance sheet liabilities classified into risk categories in accordance with the provisions of this Decision.

(2) The reports, referred to in paragraph (1) of this Article, shall be submitted by the credit institution in a form, manner and within the time limits prescribed by the Decision on supervisory reports of credit institutions and the Instructions for statistical and prudential reporting.

7 TRANSITIONAL AND FINAL PROVISIONS

Time limit for establishing internal assessment methodology for losses graded A

Article 42

The internal methodology for the assessment of losses, referred to in Article 17, paragraph (3) and Article 32, paragraph (3) of this Decision shall be established and tested by the credit institution no later than on 1 July 2011.

Decision that shall cease to have effect

Article 43

On the date of entry into force of this Decision, the Decision on the classification of placements and contingent liabilities of banks (Official Gazette 17/2003, 149/2005 and 74/2006) shall cease to have effect.

Entry into force

Article 44

This Decision shall be published in the Official Gazette and shall enter into force on 1 July 2009, with the exception of Article 17, paragraph (3) and Article 32, paragraph (3) of this Decision, which shall enter into force on 1 July 2011.

No.: 6-020/01-09/ŽR
Zagreb, 2 January 2009

Croatian National Bank
Council Chairman
Governor
Željko Rohatinski, m.