4

Banking System of the Republic of Croatia

4.1 Characteristics of the Banking System

At the end of 2000, the banking system of the Republic of Croatia comprised 43 banks and one branch of a foreign bank, as well as 26 savings banks, including four housing savings banks. The share of bank assets in the total assets of the banking sector, which amounted to HRK 114.3bn at the end of 2000, was 98.6%, whereas that of savings banks stood at 1.4%. Banks recorded profits of HRK 1,987.7m, while savings banks incurred losses amounting to HRK 45.3m. Thus, the total profit of banking system for the year was HRK 1,942.4m, compared to a profit of HRK 665.4m in 1999. Following a decline in bank assets in 1999, assets started growing again in 2000. In comparison with 1999, the assets of the system increased by 20.5%.

As shown in Table 4.1, 39 banks and one branch of a foreign bank had full authorization, which includes the performance of international credit transactions, as well as domestic and international payment transactions. Two banks had medium authorization, implying legally prescribed banking operations apart from those previously stated, whereas one bank had limited authorization, which comprises basic banking operations, as provided by Article 35 of the Banking Law. One bank did not meet the criteria for authorization, and at present, the CNB's proposal for initiating bankruptcy proceedings is being processed within the competent Commercial Court. All banks and savings banks (apart from the aforementioned bank without the operating license, which is a limited liability company) are structured, in compliance with the provisions of the Banking Law, as joint stock companies. Banks and savings banks (except housing savings banks) are of a universal type. Following the significant inflow of foreign capital into the Croatian banking sector over the last two years, the further development of the market and banking institutions can be expected, and this will be accompanied by an adequate regulatory framework.

Table 4.1 Number of Banking Institutions

Institution type	1998	1999	2000
1. Banks	60	53	44
1.1. With full authorization	53	47	39
1.2. With medium authorization	–	–	2
1.3. With limited authorization	6	5	1
1.4. Authorization not granted	–	–	1
1.5. Branches of foreign banks with full authorization	1	1	1
2. Savings banks	36	34	26
2.1. General	33	30	22
2.2. Housing savings banks	3	4	4
Total	96	87	70

Tables 4.1 and 4.2 show that the number of banks has constantly been decreasing since 1998. Out of 60 and 53 banks at the end of 1998 and 1999, respectively, there were only 44 banks remaining by the end of 2000, meaning that 9 fewer banks were in oper-

ation in 2000 compared to 1999. In contrast to 1999, when bank bankruptcies created quite a public stir, the fall in the number of banks in 2000 continued as a natural process of consolidation in the banking system. Accordingly, four banks merged with other banks during 2000[1], four bankruptcy proceedings[2] were initiated, and the license was revoked for Alpe Jadran banka d.d. In 2000, a branch of the foreign bank Societe Generale was taken over by a branch of the foreign bank Bayerische Hypo und Vereinsbank AG, München. Out of 34 savings banks that were operating at the end of 1999, only 26 banks continued operations in 2000, since operating licenses were revoked for 7 savings banks[3], and one savings bank (Adria štedionica) went bankrupt.

Table 4.2 Changes in the Number of Banking Institutions

Banks	1998	1999	2000
Number of banks at the beginning of the year	61	60	53
Banks undergoing bankruptcy proceedings	–1	–7	–4
Banks whose license was revoked	–	–	–1
Banks that merged with banks	–	–	–4
Number of banks at the end of the year	60	53	44

Savings banks	1998	1999	2000
Number of savings banks at the beginning of the year	33	35	34
Savings banks undergoing bankruptcy proceedings	–1	–1	–1
Savings banks whose license was revoked	–	–	–7
Savings banks that merged with banks	–	–1	–
New housing savings banks	+3	+1	–
Number of savings banks at the end of the year	35	34	26

In 2000, the CNB appointed a temporary administrator for two banks (Cibalae banka d.d. and Istarska banka d.d.). Cibalae banka went bankrupt in the same year, following a take over of a part of its assets by another bank, whereas the problem with Istarska banka d.d., which stirred up great public interest, was resolved by recapitalization, i.e. a majority lot of shares was purchased by a bank in majority foreign ownership.

In 2000, the Law on Bank Rehabilitation and Restructuring was repealed. In two banks[4], the rehabilitation process was completed and preparations for privatization began. The completion of the privatization of three banks[5] signaled the end of the privatization process in major banks, the rehabilitation of which was initiated in the mid 1990's. All four banks rehabilitated in this period were in majority foreign ownership at the end of 2000.

Table 4.3 shows that, over the past three years, significant changes regarding majority ownership structures occurred in banks in favor of foreign shareholders. In 1998, 10

1 Zagrebačka banka - Pomorska banka merged with Zagrebačka banka d.d.; Čakovečka banka d.d. and Trgovačka banka d.d. merged with Bjelovarska banka, now operating under a new name; Krapinsko-zagorska banka d.d. merged with Privredna banka Zagreb d.d.

2 Hrvatska gospodarska banka d.d., Agroobrtnička banka d.d., Cibalae banka d.d, Trgovačko turistička banka d.d. For Trgovačko turistička banka the proposal for initiating bankruptcy proceedings was submitted as early as mid 1999.

3 Štedionica za razvoj i obnovu; Gold štedionica; Štedionica Mediteran; Investicijsko-komercijalna štedionica; Štedionica Dugi pogled; Zagrebačka štedionica; Štedionica Grošbanak.

4 Dubrovačka banka d.d., Croatia banka d.d.

5 Privredna banka Zagreb d.d., Splitska banka d.d., Riječka banka d.d.

banks were foreign owned, and the share of their assets in total bank assets amounted to 6.7%. The number of banks in foreign ownership increased to 13 in 1999, and their share in total bank sector assets grew to 40.2%. At the end of 2000, 20 banks with assets amounting to 83.7% of total banking sector assets were in majority foreign ownership. At the end of 2000, 21 banks maintaining a 10.2% share in total banking sector assets were in the majority ownership of domestic private persons, whereas 3 banks accounting for 6.1% of total banking sector assets were in majority state ownership.

Table 4.3 Ownership Structure of Banks

Ownership structure	Number of banks			Share in total assets (%)		
	1998	1999	2000	1998	1999	2000
Banks in total or majority private ownership of domestic shareholders	42	32	21	56.4	12.7	10.2
Banks in total or majority state ownership	8	8	3	36.9	47.1	6.1
Banks in total or majority foreign ownership	10	13	20	6.7	40.2	83.7
Total	60	53	44	100.0	100.0	100.0

Table 4.4 shows banks classified by the size of their assets. The number of banks with assets larger than HRK 5bn increased over the past two years from 4 to 5 in 2000. Their share in total banking sector assets grew from 58.2% in 1999 to 65.9% in 2000, whereas the assets of these banks increased by 36% in comparison with the pervious year. Table 4.4 indicates that the number of banks with assets ranging from HRK 1bn to 5bn is on the decline (from 19 banks in 1998, i.e. 15 banks in 1999, to 13 banks in 2000). Similarly, the share of assets of this group of banks in total banking sector assets fell from 31.6% in 1999 to 25.8% in 2000 (as a result of one bank's movement into a higher group). The number of banks with assets ranging from HRK 0.5bn to 1bn varied over the past three years (9 banks in 1998, 5 banks in 1999, and 8 banks in 2000). The share of these banks' assets in total banking sector assets increased from 3.3% in 1999 to 4.6% in 2000. The number of banks with assets below HRK 0.5bn fell from 28% in 1998, i.e. 29% in 1999, to 18% in 2000. The share of assets of this bank group in total banking sector assets was reduced from 6.9% in 1999 to 3.7% in 2000.

Table 4.4 Banks by Assets Size, thousand HRK

Assets	1998	1999	2000
Assets exceeding 5,000,000	4	4	5
Assets from 1,000,000 to 5,000,000	19	15	13
Assets from 500,000 to 1,000,000	9	5	8
Assets below 500,000	28	29	18
Number of banks at the end of the year	60	53	44

4.2 The Balance Sheet Structure of the Banks

The balance sheet structure of the banks in 2000 showed an improvement in quality over that in the previous year. Following the 1998 banking crisis and the beginning of the recovery in 1999, the year 2000 saw significant strengthening in the deposit base and bank capital.

4.2.1 Bank Asset Structure

Total bank banking sector assets amounted to HRK 112.7bn at the end of 2000, which is a 20.5% increase over that at year-end 1999 when it stood at HRK 93.5bn. Loans to other clients (non-banking sector) accounted for the largest part of assets in 2000, as was the case in the previous year. These loans grew by 11.4% compared to 1999, amounting to HRK 50.5bn (in 1999, an 8.5% fall was recorded). Table 4.5 shows the downward trend of the share represented by loans in bank assets (51.2% in 1998, 48.5% in 1999, and 44.9% in 2000). Corporate loans accounted for 49%, whereas the share of household loans and all other loans accounted for 41% and 10%, respectively. Regarding the maturity structure, 45% of loans fell due within a year, whereas 55% were long-term loans. Deposits with banking institutions amounted to HRK 17.7bn, a 71.2% increase over the previous year. Their share in assets grew from 11.0% in 1999

Table 4.5 Bank Asset Structure, end of period, million HRK and %

	1998		1999			2000		
	Amount	Share	Amount	Share	Growth rate	Amount	Share	Growth rate
1. Money assets and deposits with the CNB	6,412.5	6.6	9,733.5	10.4	51.8	11,495.2	10.2	18.1
1.1. Money assets	815.2	0.8	1,245.9	1.3	52.8	1,507.5	1.3	21.0
1.2. Deposits	5,597.3	5.8	8,487.6	9.1	51.6	9,987.7	8.9	17.7
2. Deposits with banking institutions	11,459.9	11.8	10,312.5	11.0	–10.0	17,655.4	15.7	71.2
3. Treasury bills and CNB bills	1,070.8	1.1	3,139.5	3.4	193.2	6,060.2	5.4	93.0
4. Trading portfolio of securities	288.5	0.3	1,067.8	1.1	270.1	2,481.5	2.2	132.4
5. Loans to financial institutions	854.8	0.9	1,246.2	1.3	45.8	1,106.6	1.0	–11.2
6. Loans to other clients	49,591.8	51.2	45,391.5	48.5	–8.5	50,543.8	44.9	11.4
7. Investment portfolio of securities	17,747.1	18.3	15,477.1	16.5	–12.8	14,230.7	12.6	–8.1
8. Invest. in subsidiaries and related companies	2,788.5	2.9	1,768.6	1.9	–36.6	2,563.3	2.3	44.9
9. Foreclosed and repossessed assets	340.6	0.4	447.2	0.5	31.3	621.2	0.5	38.9
10. Tangible assets and software (less deprec.)	3,168.7	3.3	3,164.6	3.4	–0.1	3,324.1	2.9	5.0
11. Interests, fees and other assets	3,745.3	3.9	2,518.1	2.7	–32.8	3,308.9	2.9	31.4
12. Less: specific reserves for unidentified losses	691.3	0.7	743.6	0.8	7.6	697.2	0.6	–6.2
TOTAL ASSETS	96,777.0	100.0	93,522.9	100.0	–3.4	112,693.7	100.0	20.5

to 15.7% in 2000. Out of total deposits with banking institutions, 97.4% were deposited with foreign banks. The growth of deposits with foreign banks indicates a general unwillingness of banks to place money in loans. Both in nominal terms and in terms of the share in assets, the investment portfolio of securities displayed a downward trend (18.3% in 1998, 16.5% in 1999, and 12.6% in 2000). This decline resulted from the redemption of a part of the bonds of the Republic of Croatia, as well as a sale (accelerated by bank privatization) of previously acquired shares of banks in companies. Deposits with the Croatian National Bank (mainly reserve requirements) amounted to 8.9% of total assets, tangible assets accounted for 2.9%, whereas Ministry of Finance treasury bills and CNB bills grew, accounting for 5.4% of bank assets. According to currency structure, 30.7% of bank assets were in foreign currency.

4.2.2 Bank Liability Structure

As can be seen in Table 4.6, the share of deposits in total bank liabilities moved upward (60.5% in 1998, 60.9% in 1999, and 64.6% in 2000). In 2000, 72.8% of all deposits were denominated in foreign currency. Following a 1999 fall, deposits grew by 27.7% in 2000, amounting to HRK 72.8bn. Loans received (loans from financial institutions and other loans) moved lower, both in nominal terms and in terms of share in liabilities (22.5% in 1998, 21.6% in 1999, and 17.6% in 2000). Out of total loans received, 18% were granted by domestic financial institutions (The Croatian Bank for Reconstruction and Development, the CNB and other financial institutions), 12% by the Republic of

Table 4.6 Bank Liability Structure, end of period. million HRK and %

	1998		1999			2000		
	Amount	Share	Amount	Share	Growth rate	Amount	Share	Growth rate
1. Loans from financial institutions	4,761.3	4.9	5,282.3	5.6	10.9	4,098.9	3.6	–22.4
1.1. Short-term loans	2,142.7	2.2	2,088.7	2.2	–2.5	1,149.0	1.0	–45.0
1.2. Long-term loans	2,618.5	2.7	3,193.7	3.4	22.0	2,949.9	2.6	–7.6
2. Deposits	58,584.6	60.5	56,997.0	60.9	–2.7	72,764.5	64.6	27.7
2.1. Giro and current account deposits	9,117.0	9.4	9,216.9	9.9	1.1	12,624.9	11.2	37.0
2.2. Savings deposits	13,564.2	14.0	13,678.0	14.6	0.8	17,644.0	15.7	29.0
2.3. Time deposits	35,903.4	37.1	34,102.1	36.5	–5.0	42,495.6	37.7	24.6
3. Other loans	17,028.9	17.6	15,007.5	16.0	–11.9	15,749.6	14.0	4.9
3.1. Short-term loans	1,435.1	1.5	1,652.8	1.8	15.2	488.0	0.4	–70.5
3.2. Long-term loans	15,593.7	16.1	13,354.7	14.3	–14.4	15,261.6	13.6	14.3
4. Debt securities issued	1.1	0.0	0.0	0.0	–95.9	0.0	0.0	–100.0
4.1. Short-term debt securities issued	0.9	0.0	0.0	0.0	–94.8	0.0	0.0	–100.0
4.2. Long-term debt securities issued	0.2	0.0	0.0	0.0	–100.0	0.0	0.0	
5. Supplementary capital	492.8	0.5	343.1	0.4	–30.4	527.4	0.5	53.8
5.1. Subordinated instruments issued	–		105.5	0.1		290.0	0.3	174.8
5.2. Hybrid instruments issued	–		237.5	0.3		237.4	0.2	0.0
6. Interests, fees and other liabilities	6,553.3	6.8	4,849.2	5.2	–26.0	5,438.2	4.8	12.1
7. Profit/loss for the current year	–1,671.6	–1.7	466.4	0.5	–127.9	1,496.0	1.3	220.8
8. Capital	11,026.7	11.4	10,577.3	11.3	–4.1	12,619.1	11.2	19.3
TOTAL LIABILITIES	96,777.0	100.0	93,522.9	100.0	–3.4	112,693.7	100.0	20.5

Croatia, and 70% by foreign entities (mostly foreign financial institutions). 91.7% of the loans received had maturities longer than 1 year. Interests, fees and other liabilities accounted for 4.8% of bank liabilities.

Profit for the current year, following the loss incurred in 1998, had an upward trend. In 2000, profit for the current year accounted for 1.3% of liabilities.

4.3 Bank Capital

At the end of 2000, bank capital accounted for 11.2% of liabilities, amounting to HRK 12.6bn, which was a 19.3% increase compared to 1999 (in the same period, bank assets grew by 20.5%). In comparison with assets, capital showed a mild downward trend (11.4% in 1998, 11.3% in 1999, and 11.2% in 2000). As shown in Table 4.7, share capital amounted to HRK 8.6bn, a 4.7% increase compared to 1999. In capital structure, share capital fell, whereas retained earnings and legal reserves showed continual growth, both in nominal terms and in terms of their respective share in capital.

Table 4.7 Bank Capital Structure, end of period, million HRK and %

	1998		1999			2000		
	Amount	Share	Amount	Share	Growth rate	Amount	Share	Growth rate
1. Share capital	8,944.7	81.1	8,219.7	77.7	–8.1	8,604.7	68.2	4.7
2. Retained earnings/loss	16.7	0.2	73.7	0.7	341.0	798.4	6.3	983.7
3. Legal reserves	1,165.5	10.6	1,540.2	14.6	32.2	1,782.6	14.1	15.7
4. Reserves provided for by the articles of associations and other capital reserves	899.8	8.2	743.8	7.0	–17.3	1,433.4	11.4	92.7
TOTAL CAPITAL	11,026.7	100.0	10,577.3	100.0	–4.1	12,619.1	100.0	19.3

Risk-based capital is a calculation category to measure a bank's capability to cover possible losses. It is composed of core capital and supplementary capital which must not exceed the amount of core capital. At the end of 2000, risk-based capital in the banking system amounted to HRK 12.4bn, which is an 11% increase compared to 1999 when it amounted to HRK 11.1bn. Core capital dominated the risk-based capital structure. The capital adequacy ratio is a measure of bank solvency and stability. It is the ratio between risk-based capital and risk-weighted assets. According to the current regulations, this ratio must not be below 10%. At the banking system level, the capital adequacy ratio amounted to 21% at the end of 2000, the same as in end 1999. At the end of 2000, two banks had the minimum permitted capital adequacy ratio, 10%, whereas all other banks had a relatively high capital adequacy ratio.

Accordingly, the quality of bank capital improved compared to the previous years, especially after "the removal" of "problem" banks from the banking system. Nevertheless, the assets quality determining the amount of potential losses and a bank's capability to earn profit from the placed funds, must also be taken into account.

4.4 Bank Asset Quality

The asset quality analysis is one of the most significant elements in evaluating the operational stability of a bank. CNB decisions, issued pursuant to the Banking Law, regulate in detail the classification of a bank's placements by risk categories and the calculation of the required specific reserves for identified potential losses. Specific reserves for identified losses represent the bank's expenditure by which asset items are reduced. Therefore, specific reserves for identified losses have a significant effect on a bank's business performance. The assessment of assets quality is carried out for bank's placements (loans, placements to banks and the central bank, contingent liabilities, claims based on interest income and investment portfolio of debt securities).

Table 4.8 Classification of Bank Placements by Risk Categories, end of period, million HRK and %

Placement	1998		1999		2000	
	Amount	Share	Amount	Share	Amount	Share
A	97,227.9	85.1	92,061.5	85.5	109,284.9	87.9
B	6,377.8	5.6	4,507.0	4.2	3,561.5	2.9
C	5,574.8	4.9	3,749.9	3.5	3,111.6	2.5
D	2,718.1	2.4	3,393.6	3.2	3,904.9	3.1
E	2,359.6	2.1	3,903.3	3.6	4,507.3	3.6
Total	114,258.2	100.0	107,615.4	100.0	124,370.2	100.0

Placements that are subject to assessment are classified into the following risk categories: A, B, C, D, and E, according to the degree of risk. Risk category A includes placements that do not involve the risk of non-payment, and thus no specific reserves for identified losses are set aside for these placements, whereas for other risk categories, specific reserves for identified losses are calculated relative to the degree of risk (e.g. specific reserves for category E, involving the highest risk, amount to 100% of placements). Income includes interest from placements classified into risk categories A and B, whereas interests from placements classified into other risk categories are not included in income unless they are collected. Apart from specific reserves for identified losses, banks are also obliged to calculate specific reserves for unidentified losses to the amount of 1% of placements and off-balance sheet risky items classified into risk category A.

Table 4.9 Provision to Placement (A, B, C, D, E) Ratio of Banks, end of period, million HRK

	1998	1999	2000
1. Total provis. for ident. and unident. losses	7,645.6	9,486.2	10,055.4
1.1. Provisions for identified losses	6,951.6	8,694.7	9,126.0
1.2. Provisions for unidentified losses	694.0	791.5	929.4
2. Total gross placements (A,B,C,D,E)	114,258.2	107,615.4	124,370.2
3. Relative ratio of total provisions to total gross placements	6.7%	8.8%	8.1%

As shown in Table 4.8, risk assets classified into category A accounted for 87.9% of total risk assets at the end of 2000 (85.5% in 1999), whereas other categories together comprised 12.1% of total risk assets (14.5% in 1999). Performing categories (A and B) accounted for 90.8% of total risk assets (89.7% in 1999), and non-performing assets (grades C, D, and E) for 9.2% of total risk assets (10.3% in 1999). Specific reserves for identified and unidentified losses in 2000 amounted to HRK 10.0bn, i.e. 8.1% of total risk assets. Table 4.9 shows the provision to placement ratio over the past three years. A continuous growth in specific reserves is noticeable (particularly in 1999). The share of specific reserves in placements fluctuated (6.7% in 1998, 8.8% in 1999, 8.1% in 2000). A significant change occurred in 1999 when placements (as a result of a reduction in the number of banks) decreased in nominal terms, and reserves increased (due to the application of more strict criteria in assessing placements). Therefore, it can be asserted that the reduction in the share of reserves in placements in 2000 was a result of improved placement quality, which is confirmed by the increased share of categories A and B. It must be noted that the data for 2000 are based on non-audited reports.

4.4.1 Limitations Decreasing Risks

In accordance with the Banking Law, banks are obliged to report to the Croatian National Bank on the amount and type of their exposure, as well as to comply with the following ratios and levels of exposure regulated by the Banking Law:

- ❑ Bank exposure to a single borrower or group of related borrowers must not exceed 25% of its risk-based capital.
- ❑ Total sum of a bank's large exposures must not exceed 400% of its risk-based capital. A bank's large exposure is exposure to a single borrower or group of connected borrowers exceeding 10% of its risk-based capital.
- ❑ Bank exposure to a single shareholder with more than 3% of bank shares (and their related persons) must not exceed 5% of the bank's risk-based capital.
- ❑ A bank's investment in tangible assets (land, buildings, equipment and refurbishing of business premises) must not exceed 30% of its risk-based capital.
- ❑ A bank's investment in tangible assets together with equity participation in companies must not exceed 70% of its risk-based capital.

Banks are also obliged to report their exposure to persons with special relationships with the bank (shareholders with more than 5% of shares, members of the bank's management and supervisory board and its procurators, persons holding a contract to work under special conditions in the bank, the spouses and children of all those listed above, legal entities in which those listed hold more than 20% of the voting shares, legal entities in which a bank itself has more than 20% of the voting shares).

The purpose of the described reporting and limitations is to reduce credit risk concentration, restrict placements to shareholders, as well as to restrict bank investments in assets which are not the bank's primary activity. For banks breaching the limitations, the

Croatian National Bank may set a time limit for adjustment to the provisions on permissible limitations, as well as adjustment dynamics. Table 4.10 shows banks according to compliance with the prescribed limitations.

For 12 out of 14 banks that breached the permitted exposure to a single borrower, a deadline was established for adjusting their exposure to the prescribed limitations. The same deadline was set for 7 out of 10 banks that breached the permitted exposure to a single shareholder with more than 3% of shares. 9 banks violated the permitted total exposure to shareholders with more than 5% of bank shares, and for 6 of them, a time limit for adjustment was set. A total of 12 banks violated the provisions on the maximum amount of investment in tangible assets and 9 banks violated the provisions on the maximum amount of investment in tangible assets and equity participation. Out of these 12 (i.e. 9) banks, 5 (i.e. 4) banks were allowed temporary non-compliance.

Table 4.10 Banks according to Compliance with the Prescribed Limitations, balance as of December 31, 2000

Type of limitation	Compliant	Non-Compliant		Total number of banks
		Permitted time limit for adjusting to the prescribed limitations	Banks breaching the prescribed limitations	
Bank exposure to single borrower must not exceed 25% of risk-based capital	30	12	2	44
Total amount of large exposures must not exceed 400% of risk-based capital	43	–	1	44
Exposure to a single shareholder with more than 3% of bank shares must not exceed 5% of risk-based capital	34	7	3	44
Total exposure to shareholders with more than a 5% of bank shares must not exceed 25% of risk-based capital	35	6	9	44
Investment in tangible assets must not exceed 30% of risk-based capital	32	5	12	44
Investment in tangible assets and equity participation must not exceed 70% of risk-based capital	35	4	3	44

The number of banks that violated the limitations is smaller than in the previous year, partly as a result of adjustments in 2000, and partly because of the overall reduction in the number of banks operating. Some banks violated legally determined limitations due to their connection with certain regional industries and large companies, as well as a transfer of placements into assets and equity participation in companies over the previous years. For most of the banks, the Croatian National Bank established a time limit for adjustment. For banks breaching the limitations, but with no adjustment time limit established, the process of supervision by the CNB is under way. For one bank in violation of these limitations, bankruptcy proceedings were proposed in 2000, and the operating license was revoked for another bank in 2001.

4.5 Bank Earnings Quality

In 2000, banks reported a profit of HRK 1,987.7m. 38 out of 44 banks earned profit amounting to a total of HRK 2,134.9m, whereas 6 banks incurred a total of HRK 147.2m in losses. As shown in Table 4.11, interest income in the overall banking system amounted to HRK 8,337.3m, a 6.7% increase over 1999 levels. Interest expenses stood at HRK 4,044.3m, a 3.1% growth compared to the previous year. Net interest income in 2000 amounted to HRK 4,293.0m, representing a 10.3% increase over that in 1999. Interest income and expenses did not reach their 1998 levels, when significantly more banks were operating and interest rates were higher. Net non-interest income fell by 1.8% from the previous year, since both non-interest income and non-interest expenses were somewhat lower. Accordingly, banks did not significantly increase their non-interest income bearing activities following the drop in 1999.

Table 4.11 Bank Income Statement, million HRK and %

	1998	1999		2000	
	Amount	Amount	Change	Amount	Change
1. Net interest income	4,374.4	3,893.4	–11.0	4,293.0	10.3
1.1. Interest income	8,713.6	7,816.1	–10.3	8,337.3	6.7
1.2. Interest expenses	4,339.2	3,922.7	–9.6	4,044.3	3.1
2. Net non-interest income	1,629.7	2,035.5	24.9	1,999.7	–1.8
2.1. Non-interest income	4,507.1	2,962.4	–34.3	2,919.3	–1.5
2.2. Non-interest expenses	2,877.4	926.9	–67.8	919.6	–0.8
3. General administrative expenses and amortization	3,515.1	3,211.1	–8.6	3,519.4	9.6
4. Net operating income before provisions	2,489.0	2,717.9	9.2	2,773.3	2.0
5. Loan loss provision expenses	5,212.0	1,898.4	–63.6	762.6	–59.8
6. Pretax income/loss	–2,723.0	819.4	–130.1	2,010.7	145.4
7. Profit tax	179.8	104.8	–41.7	23.0	–78.1
8. After tax profit/loss	–2,902.9	714.6	–124.6	1,987.7	178.1

General administrative expenses and amortization amounted to HRK 3,519.4m, which was a 9.6% increase over that in the previous year. Net operating income before loan loss provisions stood at HRK 2,773.3m, up 2% over previous year levels, whereas a growth of 9.2% was recorded in 1999. Loan loss provisions fell significantly (HRK 5,212.0m in 1998; HRK 1,898.4m in 1999; HRK 762.6m in 2000). In 1998, a considerable increase in loan loss provision expenses was recorded, but following the exit of problem banks from the market in 1999, these expenses significantly decreased. This trend continued in 2000. Interest income accounted for 74.1% of the Croatian banks' income structure, an up from that in the previous year, whereas non-interest income accounted for 25.9%. Interest expenses accounted for 47.7% of the expenses structure (excluding loan loss provisions), non-interest expenses for 10.8%, and general administrative expenses for 41.3%, increasing their share in structure. As in the previous years, interest income was predominant in the income structure, whereas general administrative expenses dominated the expenses structure. Realized profit against average assets increased from 0.74% in 1999 to 1.9% in 2000. Increased profit resulted, only to some extent, from an increase in net income before provisions and was to a great extent the result of a reduction in loan loss provision expenses. The reported profit of HRK 1,987.7m was 2.7 times larger than in 1999, when it amounted to HRK 714.6m. Apart from the aforementioned reduction in loan loss provision expenses, the reported profit was also influenced by deferred tax payments related to the application of International Accounting Principle 12. It should be noted that preliminary data were used in reporting the results for 2000, and thus bank performance in 2000 may be somewhat different after the annual reports for all banks have been audited.

4.6 Bank Liquidity

Bank liquidity is, in the narrowest sense, its capability to provide the funds for settling its due liabilities. In managing liquidity, banks take into account, among other things, the variability of deposits, availability of assets that can easily be changed into cash, access to money markets, central bank lending, and asset and liability maturity structures match. In order to assure liquidity reserve, banks place part of their assets in securities bearing lower interest which, however, can easily be changed into liquid assets. Liquidity ratios that can be used are the credit to deposit ratio (about 70% is considered optimum), and the short term assets to short term liabilities ratio.

At the end of 2000, HRK 2,496.0m in CNB bills denominated in kuna were purchased (HRK 850.4m at the end of 1998, and HRK 1,348.7m at year-end 1999). HRK 1,692.7m in CNB bills denominated in foreign currency were also purchased (HRK 1,377.4m in 1998, and HRK 1,507.6m in 1999). At the end of 2000, CNB loans amounting to HRK 299.6m were utilized, compared to HRK 1,044.1m at the end of 1999. The credit to deposit ratio was 71% in end 2000 (86% in 1998; 82% in 1999). The short-term assets to short-term liabilities ratio stood at 92.3% in 2000 (88.8% – 1998; 90.1% – 1999). Thus, bank liquidity has been continually improving over the past three years.

4.7 Savings Banks Performance

At the end of 2000, 26 savings banks were in operation, of which 4 were housing savings banks. During 2000, licenses were revoked for 7 savings banks, and against one savings bank bankruptcy proceedings were initiated. Savings banks founded before the

Banking Law came into force, which were issued the operating license based on the previously valid Law on Banks and Savings Banks, must adjust their operation to the Banking Law by the end of 2001, by increasing the paid-in capital so that it amounts to a minimum of HRK 20m. All savings banks are 100% privately owned.

Total savings bank assets at the end of 2000 amounted to HRK 1,613.9m, a 25.5% increase compared to that at the end of 1999. This increase was influenced by 171.7% growth in the assets of housing savings banks; the assets of savings banks founded in accordance with the previously effective Law on Banks and Savings Banks fell however by 3.5%. The share of the assets of housing savings banks in total assets of savings banks increased from 16.5% at the end of 1999 to 35.8% at the end of 2000. Such developments were effected by a reduction in the number of savings banks as a result of the withdrawal of licenses on one hand, and the intensive growth in assets of housing savings banks on the other.

4.7.1 The Structure of Savings Banks Balance Sheet

Loans to other clients accounted for the greatest part of savings banks assets, amounting to HRK 653.3m at the end of 2000. This is a 1.4% fall compared to the previous year. Their share in total assets decreased from 51.5% in end 1999 to 40.5% in end 2000. Some items significantly increased (due to their growth in housing savings banks balance sheets), both in nominal terms and in terms of their share in savings banks assets. These items include Ministry of Finance treasury bills and CNB bills whose share in savings banks assets increased from 9.8% in 1999 to 14.8% in 2000, the trading portfolio of

Table 4.12 Asset Structure of Savings Banks, end of period, million HRK and %

	1999		2000		
	Amount	Share	Amount	Share	Change
1. Money assets and deposits with the CNB	89.8	7.0	93.2	5.7	3.9
1.1. Money assets	24.3	1.9	36.1	2.2	48.5
1.2. Deposits	65.5	5.1	57.1	3.5	–12.7
2. Deposits with banking institutions	93.1	7.2	100.3	6.2	7.7
3. Treasury bills and CNB bills	126.4	9.8	239.0	14.8	89.0
4. Trading portfolio of securities	3.1	0.2	143.9	8.9	4,590.7
5. Loans to financial institutions	50.5	3.9	11.1	0.7	–78.1
6. Loans to other clients	662.3	51.5	653.3	40.5	–1.4
7. Investment portfolio of securities	32.4	2.5	190.9	11.8	488.5
8. Investment in subsidiaries and related companies	1.4	0.1	1.4	0.1	3.7
9. Foreclosed and repossessed assets	25.8	2.0	17.7	1.1	–31.5
10. Tangible assets and software (less depreciation)	66.5	5.2	59.1	3.7	–11.0
11. Interests, fees and other assets	142.5	11.1	112.5	7.0	–21.1
12. Less: specific reserves for unidentified losses	7.6	0.6	8.5	0.5	12.7
TOTAL ASSETS	1,286.2	100.0	1,613.9	100.0	25.5

securities (increased from 0.2% in 1999 to 8.9% in 2000) and the investment portfolio of securities (up from 2.5% in 1999 to 11.8% in 2000). All other items decreased in their assets share compared to the previous year.

Deposits were dominant in the liability structure of savings banks, amounting to HRK 1,178.8m at the end of 2000. Their share in total liabilities grew from 64.2% in 1999 to 73% in 2000, whereas in nominal terms, deposits increased by 42.7%, mainly the result of deposit growth in housing savings banks. The share of all other liabilities, apart from supplementary capital, decreased compared to 1999. Supplementary capital increased from HRK 52m in 1999 to HRK 83.2m in 2000, and its share in liabilities grew from 4% at the end of 1999 to 5.2% in 2000.

Table 4.13 Liability Structure of Savings Banks, end of period million HRK and %

	1999		2000		
	Amount	Share	Amount	Share	Change
1. Loans from financial institutions	28.8	2.2	13.3	0.8	–54.0
1.1. Short-term loans	24.8	1.9	12.1	0.7	–51.4
1.2. Long-term loans	4.0	0.3	1.2	0.1	–69.9
2. Deposits	826.3	64.2	1,178.8	73.0	42.7
1.1. Giro and current account deposits	6.6	0.5	6.9	0.4	5.2
1.2. Savings deposits	38.6	3.0	46.9	2.9	21.4
1.3. Time deposits	781.1	60.7	1,125.0	69.7	44.0
3. Other loans	8.4	0.7	4.4	0.3	–48.0
1.1. Short-term loans	7.8	0.7	3.8	0.3	–51.2
1.2. Long-term loans	0.6	0.0	0.6	0.0	–5.5
4. Debt securities issued	0.0	0.0	0.0	0.0	0.0
1.1. Short-term debt securities issued	0.0	0.0	0.0	0.0	0.0
1.2. Long-term debt securities issued	0.0	0.0	0.0	0.0	0.0
5. Supplementary capital	52.0	4.0	83.2	5.2	60.1
1.1. Subordinated instruments issued	12.8	1.0	9.9	0.6	–22.4
1.2. Hybrid instruments issued	39.2	3.0	73.3	4.6	87.0
6. Interests, fees and other assets	53.0	4.1	56.4	3.5	6.4
7. Profit/loss for the current year	–41.4	–3.2	–43.4	–2.7	4.6
8. Capital	359.1	27.9	321.2	19.9	–10.6
TOTAL LIABILITIES	1,286.2	100.0	1,613.9	100.0	25.5

4.7.2 Savings Banks Capital

Savings banks capital decreased by 10.6% due to a loss incurred in 1999 and a reduction in the number of savings banks. The share of capital in total liabilities fell from 27.9% in 1999 to 19.9% in 2000. The loss incurred in 2000 will influence a further capital decrease.

At the end of 2000, the risk-based capital of savings banks amounted to HRK 310.3m, down from the HRK 336m as at December 31, 1999. Savings bank core capital decreased in 2000 due to operational losses. However, at the same time their supplementary capital (hybrid and subordinated instruments) increased and was added by savings banks to risk-based capital in accordance with the legislation.

Table 4.14 Savings Banks Capital Structure, end of period, million HRK and %

	1999		2000		
	Amount	Share	Amount	Share	Change
1. Share capital	369.4	102.8	353.5	110.1	–4.3
2. Retained earnings/loss	–46.1	–12.8	–50.4	–15.7	9.3
3. Legal reserves	13.6	3.8	3.9	1.2	–71.3
4. Reserves provided for by the articles of association and other capital reserves	22.2	6.2	14.2	4.4	–36.0
TOTAL CAPITAL	359.1	100.0	321.2	100.0	–10.6

Savings bank capital adequacy was 38% in end 1999, whereas it was 37% in end 2000. At the end of 2000, the capital adequacy in three savings banks was less than the permitted minimum of 10%.

4.7.3 Asset Quality of Savings Banks

Savings banks are obliged to perform assets quality analysis in the same manner as banks. At the end of 2000, banks classified into risk category A (for which specific reserves for unidentified losses are not calculated), a total of HRK 1,348.7m, accounted for 88.1% of gross placements of savings banks. At the end of 1999, 75.9% of savings bank gross placements were graded A. In end 2000, 11.9% of the total risk-based assets of savings banks were classified into risk categories B, C, D, and E, for which specific reserves are calculated and reported. This is a significant reduction in comparison with the 24.1% recorded in 1999. Such an improvement in asset quality was a consequence of the “removal” from the system of savings banks whose licenses were revoked, as well as the bankruptcy of one bank. For the same reason, the share of total provisions (for both identified and unidentified losses) in gross placements fell from 10.6% at the end of 1999 to 5.9% at the end of 2000.

Table 4.15 Classification of Savings Banks Placements by Risk Categories, end of period, million HRK and %

Placement	1999		2000	
	Amount	Share	Amount	Share
A	925.4	75.9	1,348.7	88.1
B	92.7	7.6	57.7	3.8
C	110.2	9.0	51.5	3.4
D	46.0	3.8	31.4	2.0
E	44.6	3.7	41.7	2.7
Total	1,218.9	100.0	1,531.0	100.0

Table 4.16 Provision to Placement (A, B, C, D, E) Ratio of Savings Banks, end of period, million HRK

	1999	2000
1. Total provisions for identified and unidentified losses	129.2	90.5
1.1. Provisions for identified losses	121.6	82.3
1.2. Provisions for unidentified losses	7.6	8.2
2. Total gross placements (A,B,C,D,E)	1,218.9	1,531.0
3. Relative ratio of total provisions to total gross placements	10.6	5.9

4.7.4 Limitations Decreasing Risks

Savings banks, identical to banks, are obliged to comply with the regulations determining ratios and levels of exposure.

As shown in Table 4.17, for savings banks violating the legal limitations, time limits were set for adjusting to the prescribed limitations, excluding one bank where the process of supervision was under way.

Table 4.17 Savings Banks according to Compliance with the Prescribed Limitations, balance as of December 31, 2000

Type of limitation	Compliant	Non-Compliant		Total number of savings banks
		Permitted time limit for adjusting to the prescribed limitations	Savings banks breaching the prescribed limitations	
Savings bank exposure to single borrower must not exceed 25% of risk-based capital	23	3	–	26
Total amount of large exposures must not exceed 400% of risk-based capital	23	3	–	26
Exposure to s single shareholder with more than 3% of shares in the savings bank must not exceed 5% of risk-based capital	21	4	1	26
Total exposure to shareholders with more than 5% shares in the savings bank must not exceed 25% of risk-based capital	23	3	–	26
Investment in tangible assets must not exceed 30% of risk-based capital	24	2	–	26
Investment in tangible assets and equity participation must not exceed 70% of risk-based capital	24	2	–	26

4.7.5 Savings Bank Earnings Quality

In 2000, savings banks incurred operational losses amounting to HRK 45.3m, implying a further deterioration in savings bank operations, following a HRK 2.3m loss in 1998 and HRK 49.2m loss in 1999. Losses totaling HRK 76m were reported by 9 savings banks, whereas 17 savings banks reported HRK 30.7m in profits.

The operational losses of housing savings banks, amounting to HRK 23m, also significantly contributed to the amount of the reported losses. These losses resulted from the fact that housing savings banks were established in 1998 and 1999 and were in their initial operational stages. Net interest income amounted to HRK 79.8m, which was a 29.9% fall compared to the previous year. General expenses and amortization increased by 4.6%. Net operating losses before loan loss provisions stood at HRK 37.2m. Loan loss provision expenses of HRK 66m in 1999 (which was an increase from 1998), were followed by a drastic fall in 2000, when they amounted to HRK 6.7m. Such a fall can to a certain extent be accounted for by license withdrawals from "problem" savings banks and their removal from the savings banks balance sheet, and a consequential growth in placements involving lower risk in the savings bank placement structure in 2000.

Table 4.18 Savings Bank Income Statement, million HRK and %

	1999	2000	Change
1. Net interest income	114.0	79.8	–29.9
1.1. Interest income	231.4	197.1	–14.8
1.2. Interest expenses	117.4	117.3	–0.1
2. Net non-interest income	26.8	11.5	–57.2
2.1. Non-interest income	60.4	62.3	3.1
2.2. Non-interest expenses	33.6	50.8	51.3
3. General administrative expenses and amortization	122.8	128.5	4.6
4. Net operating income before provisions	18.0	–37.2	–306.1
5. Loan loss provision expenses	66.0	6.7	–89.8
6. Pretax income/loss	–48.0	–43.9	–8.6
7. Profit tax	1.2	1.4	17.6
8. After tax profit (loss)	–49.2	–45.3	–8.0

4.8 The Supervision of Banks and Savings Banks

The Bank Supervision Area consists of the On-Site Supervision Department, Off-Site Supervision Department, and Department for Improving Bank Supervision. The Foreign Trade Transactions Control Department is also within the organizational structure of the Bank Supervision Area.

Following its establishment in 1993, the Bank Supervision Area within the Croatian National Bank has been gradually developed and enhanced with respect to organization and human resources. In 1999, the Area was reorganized (the Department for the Inspection of Compliance with Monetary and Foreign Exchange Policy Measures was merged with the On-Site Bank Supervision Department) and 24 new employees were recruited.

At the end of 2000, the Bank Supervision Area consisted of a total of 73 employees[6].

In 2000, as in the previous years, efforts were made regarding the ongoing training of employees, by continuing cooperation with USAID technical assistance, and providing

[6] Total number of employees does not include those employed with the Foreign Trade Transactions Control Department.

occasional internal training within the Area, as well as joint training with other areas of the Croatian National Bank. The employees participated in various seminars and training courses in Croatia and abroad and were enrolled in post-graduate studies.

In 2000, the Bank Supervision Area conducted a total of 45 examinations of banking operations (24 banks and 21 savings banks), 4 examinations of the implementation of measures for eliminating illegal and irregular activities (2 banks and 2 savings banks), as well as 6 examinations of exchange operations. The On-Site Supervision Department issued 34 examination findings based on the data on the implementation of monetary and foreign exchange policy measures. The Off-Site Supervision Department prepared 24 examination findings on the examination of a part of operations (16 for banks and 8 for savings banks). 43 orders for the improvement of conditions and the elimination of illegal and irregular activities were issued within the Bank Supervision Area (13 related to additions to, the prolongation and revocation of orders), as well as 1 order for determining illiquidity.

Over 2000, a total of 42 citations were processed (26 minor offence citations, 14 citations for economic infractions and 2 citations for infringement of currency regulations). In several banks and savings banks, the intervention of criminal and financial police was requested. In 2000, the Foreign Trade Transactions Control Department filed a total of 3,201 requests for initiating misdemeanor court proceedings for the infringement of currency regulations.

In 2000, several amendments to the regulations were adopted based on the Banking Law, which shall be applicable from 2001. The amendments were adopted for the purpose of eliminating certain misinterpretations that were observed when applying the decisions in practice.

Further strengthening of bank supervision quality is one of the strategic goals of the Croatian National Bank. Accordingly, special efforts have continued to be made to improve the compliance with the BIS Core Principles that lay down the minimum requirements for effective banking supervision, as well as to enhance the CAMEL method application, i.e. to introduce the CAMELS method into bank supervision, and to follow other European and world guidelines and standards, which themselves have constantly been improving.