

CROATIAN NATIONAL BANK

2001

ANNUAL REPORT

# 3

## Banking System of the Republic of Croatia



## 3.1 Characteristics of the Banking System

At the end of 2001, the banking system comprised 62 licensed banking institutions of which 43 were banks (42 commercial banks and one branch of a foreign bank), 15 savings banks and 4 housing savings banks.<sup>1</sup>

The total assets of the banking sector amounted to HRK 151bn at end-2001, a rise of HRK 37.6bn or 33.1% compared to end-2000. Bank assets grew by 32.9%, housing savings bank assets grew by as much as 124.6%, and savings banks assets grew by 7.4%. Savings banks and housing savings banks accounted for only 1.6% of the total assets of the banking sector. The relatively large asset growth of the banking system was partly caused by the growth of received deposits in euro-in currencies for euro conversion and partly by the large asset growth of individual banks in majority foreign ownership.

The total profit of the banking sector in 2001 was HRK 1,979.8m (HRK 1,240.1m in 2000). Banks recorded profits for the year of HRK 2,003.5m, while savings banks incurred losses of HRK 23.47m.

As shown in Table 3.1, 38 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. Three banks had medium authorization, which includes receiving all types of deposits, granting all types of loans, performing securities transactions, and other legally prescribed banking operations. One bank had limited authorization, implying limited banking operations. In compliance with the provisions of the Banking Law, all banks and savings banks are structured as joint stock companies.

Table 3.1 Number of Authorized Banking Institutions

Institution type	1999	2000	2001
1. Banks	53	43	43
1.1. With full authorization	47	39	38
1.2. With medium authorization	–	2	3
1.3. With limited authorization	5	1	1
1.4. Branches of foreign banks with full authorization	1	1	1
2. Savings banks and housing savings banks	34	26	19
2.1. Savings banks	30	22	15
2.2. Housing savings banks	4	4	4
Total	87	69	62

The number of banks remained at the 2000 level. During 2001, one bank was forced to exit the banking system<sup>2</sup>, and one savings bank was granted a bank operating license

<sup>1</sup> All financial data cited in this chapter is based on preliminary unaudited bank reports for 2001 in which losses in Riječka banka d.d., Rijeka are not reported.

<sup>2</sup> The license was revoked for Kaptol banka d.d., Zagreb.

since it had adjusted its equity capital to the provisions of the Banking Law.<sup>3</sup> The number of savings banks fell from 22 at the end of 2000 to 15 at the end of 2001. The savings banks were obliged to adjust their operation to the provisions of the Banking Law by the end of 2001, i.e. to increase the amount of paid-in equity capital to a minimum of HRK 20m. During 2001, two savings banks met the conditions for registering as banks (Primorska štedionica d.d., Rijeka, operating as Primorska banka d.d., Rijeka since the end of 2001, and Štedionica Sonic d.d, Zagreb, registered as a bank in early 2002). Four housing savings banks operated in the banking system at the end of 2001, as was the case in the previous two years.

Table 3.2 Changes in the Number of Banking Institutions

Banks	1999	2000	2001
Number of banks at the beginning of the year	60	53	43
Former savings banks which were granted bank license	–	–	+1
Banks that merged with other banks	–	–4	–
Banks undergoing bankruptcy proceedings	–7	–4	–
Banks whose license was revoked	–	–1	–1
Banks that fail to comply with the Banking Law	–	–1	–
Number of banks at the end of the year	53	43	43
Savings banks	1999	2000	2001
Number of savings banks at the beginning of the year	35	34	26
Savings banks transformed into banks	–	–	–1
Savings banks that merged with other banks/savings banks	–1	–	–2
Savings banks undergoing liquidation	–	–	–2
Savings banks undergoing bankruptcy proceedings	–1	–1	–
Savings banks whose license was revoked	–	–7	–2
New housing savings banks	+1	–	–
Number of savings banks at the end of the year	34	26	19

In 2001, foreign investor interest in the Croatian banking market continued. The share of banks in direct or indirect ownership of foreign shareholders in total bank assets grew from 86.7% in late 2000 to 89.3%. This can be accounted for by the entry of three banks into the group of banks in majority foreign ownership.<sup>4</sup> In 2001, the Consortium (UniCredito Italiano S.p.A. and Allianz AG) expressed a strong interest in purchasing a majority stake in Zagrebačka banka. In view of the fact that UniCredito already had a majority interest in Splitska banka d.d., Split, it was obliged to sell this interest in order to avoid a concentration that would threaten free market operations. In 2001, the Croatian National Bank approved the change in shareholders in Zagrebačka banka d.d., Zagreb and Splitska banka d.d., Split, which was effected in 2002. However, this did not affect the ownership structure since both banks were already in majority foreign ownership.

In late 2001, three banks were in majority state ownership: Hrvatska poštanska banka d.d., Zagreb, and two banks rehabilitated by the state (Dubrovačka banka d.d., Dubrovnik, and Croatia banka d.d., Zagreb). In 2002, Dubrovačka banka d.d., Dubrovnik was taken over by Dalmatinska banka d.d., Zadar, and Croatia banka d.d., Zagreb is expected to be sold this year.

<sup>3</sup> Primorska banka d.d., Rijeka has medium authorization.

<sup>4</sup> These are: Sisačka banka d.d., Sisak (following the purchase of its majority stake by Dalmatinska banka d.d., Zadar, which itself is in majority ownership of a foreign investment fund), Primorska banka d.d., Rijeka (by the transformation of Primorska štedionica, which was in majority foreign ownership, into a bank), and Riadria banka d.d., Rijeka (after Privredna banka d.d., Zagreb, which is in majority foreign ownership, increased its shareholding in that bank).

Table 3.3 Ownership Structure of Banks

Ownership structure	Number of banks			Share of assets in total bank assets		
	1999	2000	2001	1999	2000	2001
Banks in total or majority private ownership of domestic shareholders	30	19	16	14.5	7.6	5.6
Banks in total or majority state ownership	10	3	3	45.6	5.7	5.0
Banks in total or majority foreign ownership	13	21	24	39.9	86.7	89.3
Total	53	43	43	100.0	100.0	100.0

Table 3.4 shows the number of banks classified by the size of their assets. The number of banks with assets larger than HRK 5bn increased from 5 to 6 in 2001. This group includes Zagrebačka banka d.d., Zagreb, with assets amounting to HRK 41.1bn, and Privredna banka Zagreb d.d., Zagreb, with assets amounting to HRK 27.6bn. They are followed by Riječka banka d.d., Rijeka, Splitska banka d.d., Split and Raiffeisenbank Austria d.d., Zagreb, while Hypo Alpe-Adria-Bank d.d., Zagreb joined this group in 2001. The share of banks with assets exceeding HRK 5bn in total assets grew from 66.3% in 2000 to 70.7% in 2001. At end-2001, the assets of 14 banks ranged from HRK 1bn to 5bn. The share of this group in total bank assets fell as a result of the movement of Hypo Alpe-Adria-Bank d.d., Zagreb into the higher group. The last two groups of banks had a very small share in bank assets.

Table 3.4 Number of Banks by Asset Size  
in million HRK and %

Assets	Number of banks			Share of assets in total bank assets		
	1999	2000	2001	1999	2000	2001
Assets exceeding 5,000	4	5	6	58.2	66.3	70.7
Assets from 1,000 to 5,000	15	13	14	31.6	25.5	23.1
Assets from 500 to 1,000	5	8	7	3.3	4.6	3.3
Assets below 500	29	17	16	6.9	3.6	2.9
Number of banks at the end of the year	53	43	43	100.0	100.0	100.0

In conclusion, the characteristics of the banking system in 2001 were the following: a further increase in the share of foreign ownership, a strong interest of foreign investors in the Croatian banking market, stronger competition, and a relatively large bank asset growth. In 2001, there was stronger competition among the banks and bank groups that strengthened their position in the Croatian market.

## 3.2 The Balance Sheet Structure of the Banks

The balance sheet structure of the banks in 2001 was characterized by an unusually large growth in received deposits, as much as HRK 32bn compared to end-2000. The

banks placed part of these funds in loans (net loans grew by HRK 14.6bn in 2001) and the remaining part in other asset items, particularly cash and deposits. This led to greater bank liquidity and further interest rate reduction, but also increased credit risk due to the sharp placement growth. While bank capital grew in nominal terms as a result of the considerable asset growth, the relative ratio of bank capital to total assets trended downwards in 2001.

### 3.2.1 Bank Asset Structure

Total bank assets amounted to HRK 148.6bn at end-2001, which is a 32.9% increase over that at the end of 2000 when it stood at HRK 111.8bn.

Net loans to other clients (non-banking sector), amounting to HRK 64.7bn at the end of 2001, had a downward trend in the asset structure despite their large nominal growth. Corporate loans had the largest share in the structure of total loans (49% share), as was the case in the previous year, with an upward trend as compared to 2000. The share of household loans (42.5% of total loans) also had an upward trend, whereas the share of other loans (8.5% of total loans) had a downward trend. The share of long-term loans in total loans increased from 55% at end-2000 to 64.7% at end-2001. Figure 3.1 shows loans by the type of user.

**Table 3.5 Structure of Bank Assets**  
end of period, in million HRK and %

	1999		2000			2001		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
1. Money assets and deposits with the CNB	9,733.5	10.4	11,489.3	10.3	18.0	22,216.5	15.0	93.4
1.1. Money assets	1,245.9	1.3	1,506.3	1.3	20.9	7,843.8	5.3	420.7
1.2. Deposits	8,487.6	9.1	9,983.1	8.9	17.6	14,372.7	9.7	44.0
2. Deposits with banking institutions	10,312.5	11.0	17,695.3	15.8	71.6	23,900.1	16.1	35.1
3. Treasury bills and CNB bills	3,139.5	3.4	6,059.0	5.4	93.0	9,687.1	6.5	59.9
4. Trading portfolio of securities	1,067.8	1.1	2,462.4	2.2	130.6	4,806.8	3.2	95.2
5. Loans to financial institutions	1,246.2	1.3	1,085.6	1.0	-12.9	1,175.3	0.8	8.3
6. Loans to other clients	45,391.5	48.5	50,130.7	44.8	10.4	64,751.5	43.6	29.2
7. Investment portfolio of securities	15,477.1	16.5	14,167.5	12.7	-8.5	12,750.9	8.6	-10.0
8. Investments in subsidiaries and associates	1,768.6	1.9	2,411.0	2.2	36.3	2,296.4	1.5	-4.8
9. Foreclosed and repossessed assets	447.2	0.5	614.5	0.5	37.4	474.3	0.3	-22.8
10. Tangible assets and software (net of depreciation)	3,164.6	3.4	3,252.5	2.9	2.8	3,505.2	2.4	7.8
11. Interest, fees and other assets	2,518.1	2.7	3,169.2	2.8	25.9	4,068.4	2.7	28.4
12. Net of: Specific reserves for unidentified losses	743.6	0.8	699.4	0.6	-6.0	1,002.7	0.7	43.4
<b>TOTAL ASSETS</b>	<b>93,522.9</b>	<b>100.0</b>	<b>111,837.7</b>	<b>100.0</b>	<b>19.6</b>	<b>148,629.8</b>	<b>100.0</b>	<b>32.9</b>

Deposits with banking institutions increased by 35.1% compared to end-2000, and their share in assets grew from 15.8% at end-2000 to 16.1% at end-2001. 95.9% of total deposits with banking institutions were deposited with foreign banks. At the end of 2001, the money assets of banks amounted to HRK 7.8bn, exceeding the year-end 2000 level more than four times. Such a large increase can be accounted for by a strengthened inflow of funds into the banks at the end of the year for the purpose of the euro conversion. Deposits with the Croatian National Bank amounted to HRK 14.3bn or 9.7% of total assets. Their considerable growth of 44% was a result of an increase in the reserve requirements set aside with the Croatian National Bank (as a result of deposit growth) and a strong growth in funds in settlement accounts. As in the previous years, investments in Ministry of Finance treasury bills and CNB bills continued to grow considerably, both in nominal terms and in terms of the share in assets, amounting to HRK 9.7bn at the end of 2001, which is 6.5% of total bank assets.

The investment portfolio of securities had a downward trend, both in nominal terms and in terms of the share in total assets, as a result of redemption of a part of the bonds of the Republic of Croatia. The trading portfolio of securities grew by a significant 95%, continuing the trend of relatively fast growth that started in 1999. Banks have continuously increased their volume of securities trading, most frequently bonds of the Republic of Croatia and bonds of foreign countries and foreign financial institutions. The share of bank assets denominated in foreign currency in total assets amounted to 35%.

### 3.2.2 Bank Liability Structure

Deposits predominate in the bank liability structure and increased significantly in the reporting period, both in nominal terms and in their share in liabilities. The recent introduction of the euro as a cash payment instrument caused a deposit growth in euro-in currencies for the purpose of the euro conversion. Total deposit growth in 2001 amounted to HRK 32bn, which is a 44% increase over 2000. As in the previous years, the majority of deposits were denominated in foreign currency (74.9%). Received loans (loans from financial institutions and other loans) in the liability structure had a downward trend and their absolute value moderately decreased. 19.3% of total received loans were received from domestic financial institutions (CBRD and other financial institutions), 9.7% from the Republic of Croatia and 71% from foreign entities, among which foreign financial institutions predominate. The received loans had a similar structure in 2000. 93.9% of total received loans had maturities longer than 1 year. Interests, fees and other liabilities accounted for 4.5% of bank liabilities.

Figure 3.1

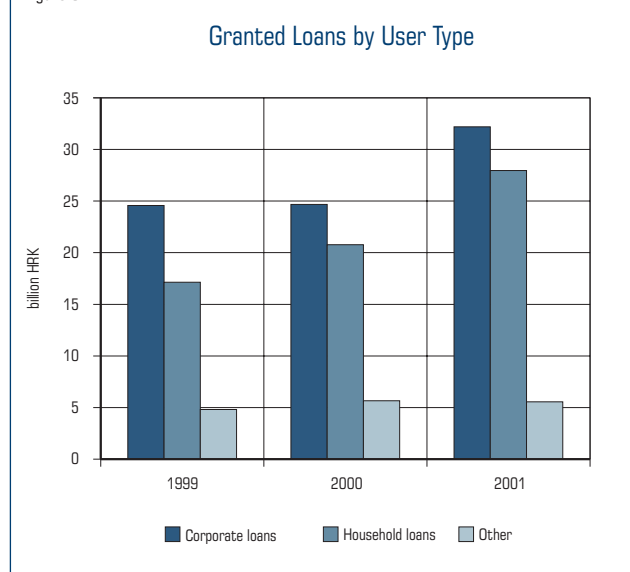


Table 3.6 Structure of Bank Liabilities  
end of period, in million HRK and %

	1999		2000			2001		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
1. Loans from financial institutions	5,282.3	5.6	3,510.9	3.1	-33.5	3,628.5	2.5	3.3
1.1. Short-term loans	2,088.7	2.2	1,130.8	1.0	-45.9	595.7	0.4	-47.3
1.2. Long-term loans	3,193.7	3.4	2,380.1	2.1	-25.5	3,032.8	2.1	27.4
2. Deposits	56,997.0	60.9	72,683.4	65.0	27.5	104,691.7	70.4	44.0
2.1. Giro account and current account deposits	9,216.9	9.9	12,619.0	11.3	36.9	16,548.1	11.1	31.1
2.2. Savings deposit	13,678.0	14.6	17,689.3	15.8	29.3	26,373.9	17.7	49.1
2.3. Time deposits	34,102.1	36.5	42,375.1	37.9	24.3	61,769.7	41.6	45.8
3. Other loans	15,007.5	16.0	16,329.0	14.6	8.8	15,947.7	10.7	-2.3
3.1. Short-term loans	1,652.8	1.8	503.3	0.4	-69.6	594.0	0.4	18.0
3.2. Long-term loans	13,354.7	14.3	15,825.7	14.2	18.5	15,353.7	10.3	-3.0
4. Debt securities issued	0.0	0.0	0.0	0.0	-	19.4	0.0	-
4.1. Short-term debt securities issued	0.0	0.0	0.0	0.0	-	0.0	0.0	-
4.2. Long-term debt securities issued	0.0	0.0	0.0	0.0	-	19.4	0.0	-
5. Supplementary capital	343.1	0.4	520.3	0.5	51.7	2,663.8	1.8	411.9
5.1. Subordinated instruments issued	105.5	0.1	282.9	0.3	168.1	347.4	0.2	22.8
5.2. Hybrid instruments issued	237.5	0.3	237.4	0.2	0.0	2,316.4	1.6	875.7
6. Interest, fees and other liabilities	4,849.2	5.2	5,475.5	4.9	12.9	6,642.7	4.5	21.3
7. Profit/loss for the current year	466.4	0.5	1,123.2	1.0	140.8	1,897.5	1.3	68.9
8. Capital	10,577.3	11.3	12,195.5	10.9	15.3	13,138.5	8.8	7.7
TOTAL LIABILITIES	93,522.9	100.0	111,837.7	100.0	19.6	148,629.8	100.0	32.9

### 3.3 Bank Capital

At the end of 2001, bank capital amounted to HRK 13.1bn, a 7.7% rise compared to 2000 (bank assets increased by 32.9% in the same period). Over the same period, share capital grew in nominal terms, but its share in total capital fell. In the capital structure, legal reserves and other reserves grew both in nominal terms and in terms of their share (as a result of profit distribution). They grew by HRK 723.6m or 21% compared to 2000.

Risk-based capital is a calculation category to measure a bank's ability to cover unexpected losses. At the end of 2001, the risk-based capital of banks amounted to HRK 13.9bn, which is a 7.8% increase over that at the end of 2000 when it stood at HRK 12.9bn. Supplementary capital, which is included in risk-based capital, had a relatively small share in the risk-based capital structure but grew nominally by 76.7% in 2001 as compared to the end of 2000. This increase can be accounted for by a significant growth in hybrid instruments issued. From mid-2001, the foreign exchange part of the reserve requirement calculation base included all received foreign exchange loans, and banks that reported liabilities based on loans from foreign banks redirected these funds into hybrid instruments. These instruments were subsequently included in the foreign exchange part of the reserve requirement calculation base.

The capital adequacy ratio at the banking system level at the end of 2001 amounted to 18.4%, which is less than at the end of 2000 when it stood at 21.3%. At the end of

2001, all banks reported capital adequacy above the minimum prescribed ratio of 10% (ranging between 10.4% and 92.2%).

Capital grew more slowly than bank assets, despite capital strengthening on the basis of distributed profit. The lower ratio of capital to assets brings the domestic banks closer to the banks in Western Europe, which is a natural trend but implies certain hazards and risks.

**Table 3.7 Structure of Bank Capital**  
end of period, in million HRK and %

	1999		2000			2001		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
1. Share capital	8,219.7	77.7	8,549.9	70.1	4.0	8,966.5	68.2	4.9
2. Retained income/loss	73.7	0.7	326.2	2.7	342.7	129.0	1.0	-60.4
3. Legal reserves	1,540.2	14.6	2,098.8	17.2	36.3	2,522.4	19.2	20.2
4. Reserves provided for by the articles of association and other capital reserves	743.8	7.0	1,220.5	10.0	64.1	1,520.6	11.6	24.6
<b>TOTAL CAPITAL</b>	<b>10,577.3</b>	<b>100.0</b>	<b>12,195.5</b>	<b>100.0</b>	<b>15.3</b>	<b>13,138.5</b>	<b>100.0</b>	<b>7.7</b>

## 3.4 Bank Asset Quality

Banks assess the quality of their assets in accordance with the internal placement classification system based on the Decision on the Classification of Placements and Assessment of Bank Exposure. This Decision was enacted pursuant to the Banking Law and prescribes the classification of bank placements (including off-balance sheet items) by risk categories. For the purpose of adjustment to International Accounting Standard 39 Financial Instruments – Recognition and Measurement, the above Decision was complemented by the Decision on the Method of Improving the Compliance of the Croatian National Bank Subordinate Legislation with the International Accounting Standards.

The placements that, prior to the enactment of the above Decision, were classified into risk categories A, B, C, D and E are now classified into three major categories. The first category encompasses fully recoverable placements, which are assessed with certainty as fully recoverable according to the debtor's financial position and available instruments of collateral (categories A and B). These placements are not subject to value impairment. The second category encompasses partly recoverable placements (categories C and D). These placements involve a loss on doubtful debts corresponding to the difference between their book value and the present value of discounted expected cash flows arising from these placements. The third category (category E) includes placements whose present value equals zero (100% loss).

Losses arising from doubtful debts and placements whose present value equals zero represent bank expenses of the amount by which the asset items are reduced and strongly affect bank performance. Although placements graded A and B are not subject to individual reduction corresponding to the value of loss, banks are obliged to form re-

serves for them for unidentified losses. For placements graded A, banks are obliged to form (set aside) reserves in compliance with the Decision on the Amount and the Method of Forming Specific Reserves to Ensure Against the Potential Losses of Banks. For placements classified into category B, banks are obliged to form reserves according to their policy, based on the Decision on the Method of Improving the Compliance of the Croatian National Bank Subordinate Legislation with the International Accounting Standards.

**Table 3.8 Classification of Bank Placements by Risk Categories**

end of period, in million HRK and %

Placements	1999		2000		2001	
	Amount	Share	Amount	Share	Amount	Share
A and B	96,568.5	89.7	112,198.3	90.5	140,821.0	92.8
C and D	7,143.6	6.6	6,923.1	5.6	6,659.1	4.4
E	3,903.3	3.6	4,803.1	3.9	4,253.3	2.8
Total	107,615.4	100.0	123,924.5	100.0	151,733.4	100.0

At the end of 2001, fully recoverable placements (categories A and B) grew by 26% compared to 2000 and accounted for 92.8% of total risk assets. Partly recoverable placements (categories C and D) and placements whose present value equals zero (category E) accounted for 4.4% and 2.8% respectively of total risk assets. As shown in Table 3.9, following a rise in 2000, total impairment (placements reduced by the amount of established losses arising from doubtful debts along with reserves for unidentified losses) fell to HRK 9.4bn in 2001, which is a level comparable to that in 1999. The share of total impairment in placements has a downward trend that was especially pronounced in 2001. This downward trend of total impairment, both in its absolute amount and relative to total placements, resulted from an increase in the share of categories A and B. This is supported by the structure of total impairment: while placement reduction by the amount of established losses arising from doubtful debts has a downward trend, specific reserves for unidentified losses have constantly been growing, both in nominal terms and in terms of their share in total reserves. The reported decline in total impairment (provisions) in 2001 can partly be accounted for by the application of International Accounting Standard 39.

**Table 3.9 Provision to Placement (A, B, C, D, E) Ratio of Banks**

end of period, in million HRK and %

	1999	2000	2001
1. Total impairment	9,476.2	10,176.6	9,444.6
1.1. Individual impairment corresponding to the value of loss	8,673.6	9,355.4	8,264.7
1.2. Provisions for unidentified losses	802.6	821.2	1,179.9
2. Total gross placements (A, B, C, D, E)	107,165.1	123,924.5	151,733.4
3. Relative ratio of total provisions to total gross placements	8.8%	8.2%	6.2%

### 3.4.1 Prescribed Limitations

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

- ❑ Bank exposure to a single borrower or group of related borrowers must not exceed 25% of its risk-based capital.
- ❑ The total sum of 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 related 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.

The purpose of these limitations is to limit the risk to which a bank is exposed in its operation in view of the amount and concentration of granted loans and investments. For banks that have violated the provisions of the Banking Law, i.e. subordinate legislation enacted on the basis of the Banking Law and referring to exposure and investment limitations, the Croatian National Bank may prescribe measures for improving the bank's condition. These measures set a time-limit for a bank violating a particular limitation to adjust to the limitation. Practice shows that the most frequent non-compliance with the limitations concern bank exposure to a single borrower or group of related borrowers, which indicates that some banks are related to individual groups of companies or industries.

## 3.5 Bank Earnings Quality

In 2001, the banks reported a profit of HRK 2,003.5m. 38 of the 43 banks earned profit amounting to a total of HRK 2,147.7m, whereas 5 banks incurred losses amounting to a total of HRK 144.2m in. As shown in Table 3.10, net interest income increased by 6.8% as compared to 2000 due to interest income growth larger than interest expenses growth. Net non-interest income rose by 11.3% compared to the previous year due to a growth in non-interest income that was larger than the growth in non-interest expenses. The share of interest income in the structure of income varied between 72% and 74% in all three reporting years, indicating that it still accounts for the largest part of bank income (although banks increased the volume of their non-interest income bearing activities). Net interest income against average interest bearing assets fell from 4.6% in 2000

to 3.9%, since interest income growth was slower than assets growth. The share of interest expenses in the expenses structure (before loan loss provisions) was 46% (downward trend), non-interest expenses had a share of 11%, and general administrative expenses and depreciation had a share of 43% (upward trend).

Table 3.10 Bank Income Statement  
in million HRK and %

	1999	2000		2001	
	Amount	Amount	Change	Amount	Change
1. Net interest income	3,893.4	4,325.1	11.1	4,618.8	6.8
1.1. Interest income	7,816.1	8,398.0	7.4	8,933.0	6.4
1.2. Interest expenses	3,922.7	4,073.0	3.8	4,314.2	5.9
2. Net non-interest income	2,035.5	1,980.6	-2.7	2,204.8	11.3
2.1. Non-interest income	2,962.4	2,878.8	-2.8	3,226.9	12.1
2.2. Non-interest expenses	926.9	898.1	-3.1	1,022.1	13.8
3. General administrative expenses and depreciation	3,211.1	3,577.7	11.4	3,991.0	11.6
4. Net operating income before provisions	2,717.9	2,728.0	0.4	2,832.6	3.8
5. Loan loss provision expenses	1,898.4	1,298.6	-31.6	682.7	-47.4
6. Pre-tax profit/loss	819.4	1,429.4	74.4	2,149.9	50.4
7. Income tax	104.8	123.3	17.7	146.4	18.7
8. After-tax profit/loss	714.6	1,306.1	82.8	2,003.5	53.4

The 47.4% reduction in loan loss provision expenses is a result of the previously reported increase in fully recoverable placements along with a fall in partly recoverable placements and placements whose present value equals zero.

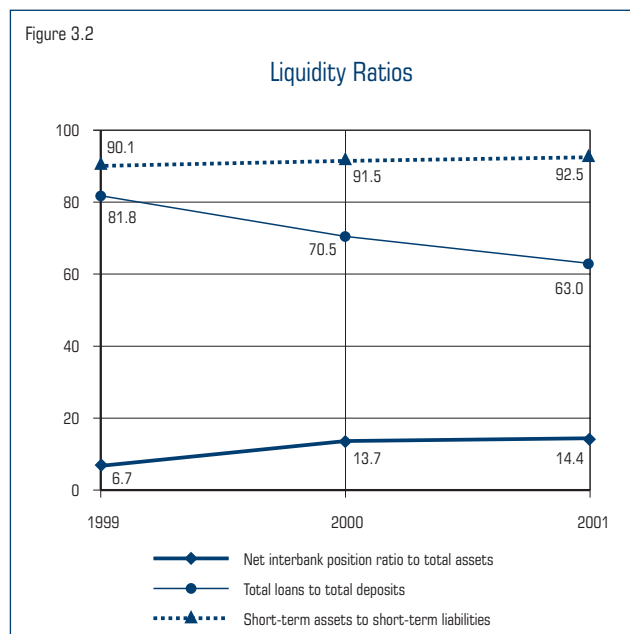
Earned profit grew by 53.4% over that in the previous year, increasing against average assets from 1.39% in 2000 to 1.65% in 2001. The reduction in loan loss provision expenses rather than the increase in net income before provisions contributed most to profit growth.

## 3.6 Bank Liquidity

Maintaining optimum liquidity is one of the permanent tasks of a bank. When managing liquidity, banks take into account, among other things, the stability of the received deposits, the availability of assets that can easily be converted into cash, access to money markets, central bank lending, and the asset and liability maturity structure

match. In order to assure their liquidity reserve, banks place part of their assets in securities that bear lower interest and can easily be converted into liquid assets. Figure 3.2 shows some liquidity ratios trends at the level of all deposit money banks. The net interbank position ratio represents the difference between assets placed with financial institutions and assets received from financial institutions, relative to total assets. The changes in this ratio, as well as in the other liquidity ratios shown, indicate that bank liquidity has been constantly growing over the past three years. Data on subscribed CNB bills also point to the same conclusion.

According to the average daily balances for December 2001, HRK 2,656.2m in CNB bills denominated in kuna were purchased (HRK 1,348.7m in 1999 and HRK 2,496.0m in 2000). HRK 1,892.7m of CNB bills denominated in foreign currency were also purchased (HRK 1,507.6m in 1999 and HRK 1,692.7m in 2000). At the end of 2001, CNB loans were not utilized by any of the banks. The high liquidity of banks in 2001 was mostly due to the previously mentioned deposit growth in bank liabilities, amounting to as much as 44% compared to 2000.



## 3.7 Savings Banks and Housing Savings Banks Performance

At the end of 2001, 15 savings banks and 4 housing savings banks were in operation. All the savings banks were in private ownership. Savings banks founded before the Banking Law came into force, which were issued with operating licenses according to the previously valid Law on Banks and Savings Banks, had to adjust their operation to the Banking Law by the end of 2001 and increase their paid-in capital to a minimum of HRK 20m. As already reported, during 2001 two savings banks increased their equity capital (Primorska štedionica d.d., Rijeka, operating as Primorska banka d.d., Rijeka since the end of 2001, and Štedionica Sonic d.d., Zagreb, registered as a bank in early 2002). Two savings banks entered the liquidation process in 2001, the licenses of two savings banks were revoked, and two savings banks merged with other savings banks. Savings banks assets amounted to HRK 2,372m at the end of 2001, a 50.4% increase compared to total savings banks assets at the end of 2000. This increase was mostly due to the asset growth of housing savings banks of 124.6%, whereas the assets of other savings banks rose by only 7.4%. The share of housing savings bank assets in total savings bank assets grew from 36.6% at the end of 2000 to 54.7% at the end of 2001.

### 3.7.1 The Structure of Savings Banks and Housing Savings Banks Balance Sheet

Following a fall in 2000, loans to other clients increased by 10.1% in 2001, but their share in savings bank assets in the reporting period had a downward trend. As in the previous year, all securities items (Ministry of Finance treasury bills, CNB bills, trading portfolio of securities, investment portfolio of securities) recorded a significant growth, both in nominal terms and in terms of their share in savings bank assets, as a result of their growth in housing savings bank assets. In comparison with the previous year, the share of money assets and deposits with the CNB increased, while the share of other items in savings bank and housing savings bank assets decreased.

Deposits were dominant in the liability structure of savings and housing savings banks, amounting to HRK 1,959.2m at the end of 2001. Their share in total liabilities had an upward trend, growing by 63.7% in nominal terms compared to 2000, mainly as a result of deposit growth in housing savings banks. The share of all other liability items in total liabilities was lower than in 2000.

Table 3.11 Structure of Savings Bank and Housing Savings Bank Assets  
end of period, in million HRK and %

	1999		2000			2001		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
1. Money assets and deposits with the CNB	89.8	7.0	91.6	5.8	2.1	154.4	6.5	68.5
1.1. Money assets	24.3	1.9	34.5	2.2	42.1	54.5	2.3	57.9
1.2. Deposits	65.5	5.1	57.1	3.6	-12.8	99.9	4.2	74.9
2. Deposits with banking institutions	93.1	7.2	99.0	6.3	6.3	123.3	5.2	24.6
3. Treasury bills and CNB bills	126.4	9.8	237.3	15.0	87.7	418.9	17.7	76.5
4. Trading portfolio of securities	3.1	0.2	144.4	9.2	4,605.6	432.7	18.3	199.7
5. Loans to financial institutions	50.5	3.9	10.8	0.7	-78.7	14.4	0.6	34.4
6. Loans to other clients	662.3	51.5	625.7	39.7	-5.5	688.9	29.0	10.1
7. Investment portfolio of securities	32.4	2.5	190.9	12.1	488.4	376.5	15.9	97.3
8. Investments in subsidiaries and associates	1.4	0.1	1.4	0.1	2.6	1.1	0.0	-18.1
9. Foreclosed and repossessed assets	25.8	2.0	17.7	1.1	-31.3	16.2	0.7	-8.4
10. Tangible assets and software (net of depreciation)	66.5	5.2	57.2	3.6	-14.0	56.3	2.4	-1.5
11. Interest, fees and other assets	142.5	11.1	109.6	6.9	-23.1	98.1	4.1	-10.5
12. Net of: Specific reserves for unidentified losses	7.6	0.6	7.9	0.5	4.6	8.8	0.4	12.0
<b>TOTAL ASSETS</b>	<b>1,286.2</b>	<b>100.0</b>	<b>1,577.6</b>	<b>100.0</b>	<b>22.7</b>	<b>2,372.0</b>	<b>100.0</b>	<b>50.4</b>

Table 3.12 Structure of Savings Bank and Housing Savings Bank Liabilities  
end of period, in million HRK and %

	1999		2000			2001		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
1. Loans from financial institutions	28.8	2.2	13.6	0.9	-52.8	3.5	0.1	-74.1
1.1. Short-term loans	24.8	1.9	12.4	0.8	-50.1	2.5	0.1	-79.8
1.2. Long-term loans	4.1	0.3	1.2	0.1	-69.9	1.0	0.0	-15.9
2. Deposits	826.3	64.2	1,197.0	75.9	44.9	1,959.3	82.6	63.7
2.1. Giro account and current account deposits	6.6	0.5	7.0	0.4	5.5	6.6	0.3	-5.9
2.2. Savings deposit	38.6	3.0	46.9	3.0	21.4	46.8	2.0	-0.2
2.3. Time deposits	781.1	60.7	1,143.2	72.5	46.4	1,905.9	80.3	66.7
3. Other loans	8.4	0.7	4.4	0.3	-48.0	1.2	0.0	-73.1
3.1. Short-term loans	7.8	0.6	3.8	0.2	-51.2	1.2	0.0	-69.1
3.2. Long-term loans	0.6	0.0	0.6	0.0	-5.5	0.0	0.0	-100.0
4. Debt securities issued	0.0	0.0	0.0	0.0	-	0.0	0.0	-
4.1. Short-term debt securities issued	0.0	0.0	0.0	0.0	-	0.0	0.0	-
4.2. Long-term debt securities issued	0.0	0.0	0.0	0.0	-	0.0	0.0	-
5. Supplementary capital	52.0	4.0	52.5	3.3	1.1	27.8	1.2	-47.2
5.1. Subordinated instruments issued	12.8	1.0	7.9	0.5	-38.4	3.9	0.2	-50.4
5.2. Hybrid instruments issued	39.2	3.0	44.7	2.8	14.0	23.9	1.0	-46.4
6. Interest, fees and other liabilities	53.0	4.1	64.5	4.1	21.7	77.6	3.3	20.3
7. Profit/loss for the current year	-41.4	-3.2	-66.1	-4.2	59.6	-27.2	-1.1	-59.0
8. Capital	359.1	27.9	311.6	19.8	-13.2	329.8	13.9	5.8
TOTAL LIABILITIES	1,286.2	100.0	1,577.6	100.0	22.7	2,372.0	100.0	50.4

### 3.7.2 Savings Bank and Housing Savings Bank Capital

Following a fall in 2000, savings bank and housing savings bank capital increased by 5.8% in 2001 due to an increase in the share capital of housing savings banks. The other capital items had a downward trend as a result of operating losses incurred by savings banks in the reporting period. The share of capital in total liabilities fell from 27.9% at the end of 1999 and 19.8% in 2000 to 13.9% at the end of 2001.

Table 3.13 Structure of Savings Bank and Housing Savings Bank Capital  
end of period, in million HRK and %

	1999		2000			2001		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
1. Share capital	369.4	102.9	339.5	109.0	-8.1	376.4	114.2	10.9
2. Retained income/loss	-46.1	-12.8	-52.9	-17.0	14.7	-63.2	-19.2	19.6
3. Legal reserves	13.6	3.8	4.0	1.3	-71.0	3.6	1.1	-7.9
4. Reserves provided for by the articles of association and other capital reserves	22.2	6.2	21.0	6.7	-5.3	13.0	3.9	-38.3
TOTAL CAPITAL	359.1	100.0	311.6	100.0	-13.2	329.8	100.0	5.8

At the end of 2001, the risk-based capital of savings banks and housing savings banks amounted to HRK 294.8m, up from HRK 257.3m as at 31 December 2000. Risk-based capital was lower than the reported total capital since it included loss for the current

year. The capital adequacy ratio of savings banks and housing savings banks stood at 37.3% at the end of 2001, compared to 37% at the end of 2000. Considerably high capital adequacy was reported by housing savings banks due to low risk-weighted assets (low credit activity).

### 3.7.3 Asset Quality of Savings Banks and Housing Savings Banks

At the end of 2001, fully recoverable placements (categories A and B) accounted for 93.6% of total risk assets of savings banks and housing savings banks. Partly recoverable placements (categories C and D) accounted for 4.4% of total risk assets, while non-recoverable placements (category E) accounted for 2% of total risk assets. Total impairment (placement reduction by the amount of established losses arising from doubtful debts together with reserves for unidentified losses) amounted to HRK 82.0m or 4.6% of total placements at the end of 2001. It had a downward trend in the reporting period, both in nominal terms and in terms of share in total placements. Despite the favorable trend in the described ratios, the quality and structure of savings bank and housing savings bank assets do not earn income and operating losses were incurred in the reporting period.

**Table 3.14 Classification of Savings Bank and Housing Savings Bank Placements by Risk Categories**  
end of period, in million HRK and %

Placements	1999		2000		2001	
	Amount	Share	Amount	Share	Amount	Share
A and B	1,018.1	83.5	1,239.1	90.5	1,679.6	93.6
C and D	156.3	12.8	86.8	6.3	79.1	4.4
E	44.6	3.7	43.8	3.2	35.7	2.0
Total	1,218.9	100.0	1,369.6	100.0	1,794.4	100.0

**Table 3.15 Provision to Placement (A, B, C, D, E) Ratio of Savings Banks and Housing Savings Banks**  
end of period, in million HRK and %

	1999	2000	2001
1. Total impairment	129.2	94.9	82.0
1.1. Individual impairment corresponding to the value of loss	121.6	87.2	73.2
1.2. Provisions for unidentified losses	7.6	7.7	8.8
2. Total gross placements (A, B, C, D, E)	1,218.9	1,369.6	1,794.4
3. Relative ratio of total provisions to total gross placements	10.6%	6.9%	4.6%

### 3.7.4 Savings Bank and Housing Savings Bank Earnings Quality

In 2001, savings banks and housing savings banks incurred operating losses amounting to HRK 23.7m. Losses totaling HRK 15.3m were reported by housing savings banks, while other savings banks reported losses of HRK 8.3m.

Net interest income in 2001 amounted to HRK 91m, a 19.6% rise compared to the previous year. Net non-interest income also grew considerably. Despite the described favorable trends, net operating losses before forming (setting aside) loan loss reserves, after general expenses and depreciation, amounted to HRK 8.5m. It can be concluded that savings banks and housing savings banks could not earn net operating income with the existing asset structure. This can partly be accounted for by housing savings banks, since they still do not generate high income from interest on loans.

Table 3.16 Savings Bank Income Statement  
in million HRK and %

	1999	2000		2001	
	Amount	Amount	Change	Amount	Change
1. Net interest income	114.0	76.0	-33.3	90.9	19.6
1.1. Interest income	231.4	193.8	-16.2	208.6	7.6
1.2. Interest expenses	117.4	117.8	0.3	117.7	-0.1
2. Net non-interest income	26.9	9.9	-63.2	46.8	373.2
2.1. Non-interest income	60.4	72.1	19.3	101.3	40.5
2.2. Non-interest expenses	33.6	62.2	85.4	54.5	-12.4
3. General administrative expenses and depreciation	122.8	131.1	6.8	146.2	11.5
4. Net operating income before provisions	18.0	-45.3	-351.0	-8.5	-81.2
5. Loan loss provision expenses	66.0	16.2	-75.5	11.4	-29.6
6. Pre-tax profit/loss	-48.0	-61.4	27.9	-19.9	-67.6
7. Income tax	1.2	4.6	278.4	3.8	-17.9
8. After-tax profit/loss	-49.2	-66.0	34.1	-23.7	-64.1

## 3.8 The Supervision of Banks and Savings Banks

### 3.8.1 Bank Supervision Function and Organization

The objective of the bank supervision function is to protect savers and depositors and to safeguard the stability and safety of the banking system. To this end, compliance of bank operations with the law and banking risk management are examined.

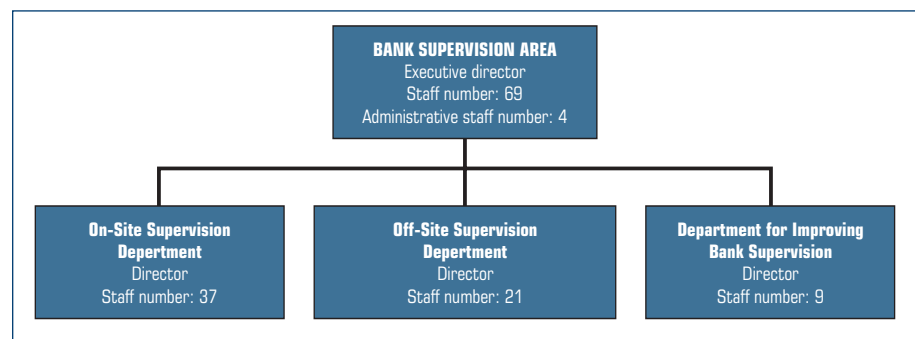
The central bank cannot by itself, through its prudential supervision function, assure the overall stability of the banking system. As in many other cases, it is necessary to co-ordinate the work of all the important entities that, acting within their authorities, may contribute to achieving and maintaining the stability and safety of the system. The role of prudential bank supervision is to constantly implement measures with the aim of minimizing all types of risks and to promptly solve individual problems in order to prevent possible adverse effects on the overall system.

For the purpose of the effective and efficient performance of its tasks, the prudential supervision of banking institutions requires a legal framework that allows quality and independent functioning. In this context, the recommendations of developed countries with a long tradition of prudential supervision are contained in the 25 BIS core principles for effective prudential bank supervision, which provide the minimum required framework for the effective performance of supervisors/supervisory institutions.

The Croatian National Bank performs supervision of banks and savings banks pursuant to the authorities prescribed by the Law on the Croatian National Bank and the Banking Law. Prudential bank supervision, established in 1993 as the Bank Supervision Area within the Croatian National Bank, has followed the BIS recommendations since its establishment and has continuously enhanced its performance, which depends, among other things, on the conditions in the environment.

Since its establishment, there have been significant improvements in prudential bank supervision within the Croatian National Bank. The Bank Supervision Area has been organizationally structured and new staff has been recruited, most of the basic regulations have been adopted, the staff has undergone professional training and regular bank supervision has started.

In order to perform all the prudential bank supervision tasks more efficiently and effectively, the Bank Supervision Area is divided into three departments: the On-Site Supervision Department, the Off-Site Supervision Department and the Department for Improving Bank Supervision. The Foreign Trade Transactions Control Department is also within the organizational structure of the Bank Supervision Area. At the end of 2001, the Bank Supervision Area had a staff of 69<sup>5</sup>. The organizational strengthening was in compliance with the Strategic Development Plan.



<sup>5</sup> The total number of employees does not include those employed with the Foreign Trade Transactions Control Department nor those responsible for administrative tasks.

## On-Site Supervision Department

The main function of this department is the on-site supervision of banks and savings banks. CNB employees examine bank operations in the bank itself, checking that procedures are applied and that the bank and savings bank business records are true and correct, in accordance with the regulations. They also assess the methods of business process management with the aim of minimizing all types of operational risks.

### Ongoing activities:

#### A On-site supervision preparation

- 1) Mathematical and logical examination of data received from the Off-Site Supervision Department;
- 2) Individual analysis of bank and savings bank financial position;
- 3) Co-operation with other departments of the Croatian National Bank regarding on-site supervision;
- 4) On-site supervision planning concerning human resources and supervision period;
- 5) Communication with the bank or savings bank regarding the preparations for the on-site supervision.

#### B On-site supervision

- 1) Supervision of bank and savings bank operation by examining business records, bookkeeping and other documentation, on-site examination of prescribed reports in order to assure that they operate on the principles of liquidity, safety and profitability;
- 2) Supervising whether the activities are performed in accordance with the operating license;
- 3) Supervision of capital adequacy, formation and amount;
- 4) Supervision of asset quality, risk grades of asset and appropriate off-balance sheet items;
- 5) Supervision of the method of providing and maintaining liquidity;
- 6) Supervision of the management method and adequacy;
- 7) Supervision of the profit amount and distribution;
- 8) Supervision of the adequacy of managing credit, interest rate, currency, market and other risks arising from operation;
- 9) Supervision of payment transaction performance;
- 10) Supervision of compliance with the law, subordinate legislation and regulations, as well as banks' or savings banks' by-laws regulating their operation;
- 11) Supervision of other bank or savings bank operating conditions, when needed, which directly or indirectly influence their operating liquidity, safety and profitability;
- 12) Meetings with the management and supervisory board;
- 13) Issuing conclusions determining the time-limit for updating records and accounts in case of irregular and untimely bookkeeping and other records, as well as original documentation based on which entries are made and records updated;
- 14) Control of the implementation of the current monetary and foreign exchange policy measures;
- 15) Co-operation with other departments of the Croatian National Bank regarding on-site supervision.

### C On-site supervision final activities

- 1) Meetings with the management and supervisory board;
- 2) Preparing the Information on the performed on-site examination;
- 3) Drawing up a written document, following the on-site examination, by the authorized person and presenting the document to the bank or savings bank;
- 4) Taking measures against a bank or savings bank, as well as against responsible persons in the case of identified illegal or irregular activities; filing a request for initiating minor offence or criminal procedures in accordance with the regulations;
- 5) Drawing up a proposal for the activities aimed at eliminating irregular operations, or an order for the elimination of irregular activities.

### D Other activities

- 1) Issuing instructions for preparing the on-site examination findings;
- 2) Issuing instructions for preparing the information technology examination findings;
- 3) Issuing a manual for performing information technology supervision;
- 4) Co-operation with other departments within the Area for the purpose of setting up the Central Banks' Records;
- 5) Participation in task forces at the Croatian National Bank level for certain projects;
- 6) Participation in the task force for the implementation of the UN Security Council Resolution on fighting terrorism (with other government bodies);
- 7) The organization and keeping of records on the supervision carried out and measures taken;
- 8) Establishing, documenting, monitoring and compiling banks' ratings based on the CAMELS method;
- 9) Documenting, monitoring, initiating supervision, and supervising the implementation of activities aimed at eliminating irregular operations, or orders for the elimination of illegal and irregular activities;
- 10) Testifying in minor offence and criminal procedures against banks and savings banks;
- 11) Co-operation with other departments of the Croatian National Bank;
- 12) Co-operation with other government bodies regarding issues in the area of bank and savings bank supervision (Money Laundry Office, Ministry of the Interior, Foreign Exchange Inspectorate, State Attorney's Office, etc.).

## Off-Site Supervision Department

The main function of this department is the ongoing analysis of the financial position of individual banks or savings banks and the overall system, on the basis of received data. These analyses should be a guideline for on-site supervision and a preventive means in the form of corrective measures against particular banks or savings banks.

Ongoing activities:

#### A Tasks related to individual banks

- 1) Collection of data and reports in certain intervals (quarterly preliminary reports, annual audited reports, annual consolidated reports);
- 2) Mathematical and logical examination of the collected data;
- 3) Processing and compilation of the collected data;
- 4) Periodical analysis of individual bank and savings bank financial standing, and determining a bank's rating according to the CAMELS method;
- 5) Audit reports analysis, on which a special report is prepared;
- 6) Providing information on individual bank operation as a preparation for meetings with bank representatives and drawing up minutes of meetings;
- 7) Filling in the Banks' Records with various data on individual banks and savings banks;
- 8) Preparing data for the Banks Bulletin;
- 9) Initiating the on-site supervision of a bank or savings bank when there are indications, based on data analysis, of possible illegal activities and jeopardized safety, liquidity or profitability;
- 10) Preparing examination reports or prescribing measures in the case of confirmed illegal or irregular activities of a bank or savings bank;
- 11) Monitoring the implementation of the measures prescribed by the Order;
- 12) Communication and correspondence with other departments of the Croatian National Bank, banks, savings banks, various institutions and individuals (e.g. responses to banks' inquiries and to savers' and other bank clients' complaints).

#### B Activities related to banking system analysis

- 1) Determining certain indicators and analyses of the overall banking system; for example, analysis of the banking system for the CNB Annual Report, drawing up quarterly reports on the banking sector;
- 2) Receiving and processing the reports on debtors whose borrowing exceeds HRK 5m, preparing the report and presenting it to the Area and CNB management;
- 3) Collecting data at the banking system level, as required by the IMF and other international institutions, as well as participation in the meetings with the representatives of these institutions.

#### C Licensing<sup>6</sup>

- 1) Processing applications and making proposals to the Licensing Committee for particular bank operation areas; for example: issuing and revoking the operating license of a bank, approvals for acquiring an interest in bank equity capital, approvals for exceeding the limitation on investment in tangible assets and equity participation, bank merger and acquisition, compliance with the law and other regulations;

<sup>6</sup> From 1 February 2002, licensing activities are performed by the Department for Improving Bank Supervision.

- 2) Processing applications and making proposals related to savings and loan co-operatives to the Licensing Committee.

#### D Other activities

- 1) Participation in the data base and information system development for analyzing bank financial reports and the overall banking system;
- 2) Preparation of the manual for the Department's operations;
- 3) Participation in task forces at the level of the Area and CNB for particular projects (preparing draft regulations);
- 4) Co-operation with other departments within the Area regarding the preparation of the Central Banks' Records.

### Department for Improving Bank Supervision

The main function of this department is the monitoring of the application of prudential regulation and proposing improvements, the development and improvement of internal work methodologies, the monitoring of international trends and co-operation with other institutions.

#### Ongoing activities:

- 1) Improvement and development of Bank and Savings Bank Supervision Methodology;
- 2) Monitoring and studying international bank standards;
- 3) Monitoring regulations, studies and other literature on bank and savings bank supervision, as well as informing other departments within the Area thereof;
- 4) Studying and proposing bank and savings bank supervision regulations;
- 5) Developing the data base and information system for bank financial reports and overall banking system analysis;
- 6) Transparency improvement for the purpose of informing the public on bank operation (Banks Bulletin);
- 7) Organizing and carrying out Area employee training;
- 8) Stating opinions regarding individual inquiries about the application of laws and other regulations, in co-operation with other departments;
- 9) Co-operation with other departments of the Croatian National Bank and other government bodies in carrying out projects;
- 10) Maintaining contacts with bank supervisory authorities in other countries as part of co-operation and mutual assistance in banking system supervision;
- 11) Participating in meetings with representatives of domestic and international financial institutions and organizations, domestic and foreign prudential supervisory institutions, foreign banks, etc.

### 3.8.2 The Bank Supervision Area's Activities in 2001

The outcome of the Bank Supervision Area's regular activities in 2001 was as follows:

- ❑ a total of 32 regular examinations of banking operations were conducted (in 23 banks and in 9 savings banks), which accounts for 52.46% of the banking system in terms of the number of institutions or 52.98% of the banking system in terms of the share in assets (in 2000, on-site supervision was performed in 24 banks and 21 savings banks, which is 56.46% of the overall system),
- ❑ 6 examinations of the implementation of measures for the improvement of condition were conducted (in 2 banks and 4 savings banks,)
- ❑ 3 examinations of liquidation process were carried out (in 2 banks and 1 savings bank),
- ❑ 6 off-site examination findings were prepared,
- ❑ 29 orders for the improvement of conditions and the elimination of illegal and irregular activities were issued – these measures partly refer to the establishment of time-limits for complying with prescribed exposure limitations,
- ❑ 28 citations were processed (11 minor offence citations, 6 citations for financial infractions and 11 citations for infringement of currency regulations).

Additionally, in accordance with the provisions of the Banking Law, a total of 67 applications of banks and savings banks for various approvals were processed, which resulted in issuing bank operating licenses (3), granting approvals for exceeding the investment limitations (15), extending time-limits set by various decisions (5), granting specific prior consents (42) and withdrawing licenses (2).

In 2000, the majority of activities and resources were directed towards solving problems that remained from the previous years and towards completing the banking system consolidation process. Although more examinations of banking operations were conducted in 2000, the banks examined in 2001 were considerably larger by size and volume of operations than the banks examined in the previous year.

## Regulation

### Banking Bill

Since the enactment of the basic regulations in 1993, they have constantly been amended and improved for the purpose of improved compliance with the BIS core principles for effective banking supervision, International Accounting Standards and EU Guidelines. The current Banking Law of 1998 allowed the Croatian National Bank to act efficiently in mitigating the consequences of the 1998/99 banking crisis.

For the purpose of further compliance with the European Union regulation, a Banking Bill was prepared, which is presently in the process of enactment by the Croatian Parliament. The aim of the Banking Bill is to create the preconditions for regular banking operation through a high level of prevention, which primarily must be assured by the banks themselves. Pursuant to the new Banking Law, new subordinate legislation will also be adopted.

The Banking Bill introduces new provisions or amends the existing provisions, of which

most important are the following:

- provisions on the freedom of banks of the EU Member States to provide banking and other financial services;
- provisions on co-operation with other supervisory authorities, with a special emphasis on co-operation with the supervisory authorities of the EU Member States;
- provisions on risk management, including market risk and other risks;
- provisions on bank supervision on the basis of consolidated financial reports;
- provisions on the legal protection of persons authorized for bank supervision;
- provisions allowing the Croatian National Bank to monitor market competition in the banking services market and to take appropriate measures for assuring the same;
- consumer protection provisions;
- provisions on special administration (which should allow the greater efficiency of the special administration appointed by the Croatian National Bank).

## Other Regulation

In co-operation with the Research and Statistics Department, and for the purpose of better consumer protection, the Decision on the Uniform Method of Expressing the Effective Lending and Deposit Interest Rate was adopted. For the purpose of improving the compliance of the existing subordinate legislation with International Accounting Standard 39 – Recognition and Measurement, the Decision on the Method of Improving the Compliance of the Croatian National Bank Subordinate Legislation with the International Accounting Standards was also issued.

Additionally, considerable efforts were made within the Bank Supervision Area in the following operating segments:

- improvement of transparency in informing the public about the conditions in the system (the Banks Bulletin publication was started),
- internal organization and procedure improvement (internal reorganization was carried out and supervisory function operating procedures were prepared),
- development of the data base and information system for the banking system financial report and overall banking system analysis,
- further improvement in the application of the CAMELS method in the area of bank supervision in general,
- setting up the Central Banks' Records,
- co-operation with other government bodies regarding issues related to the area of bank and savings bank supervision,
- co-operation with government bodies from other countries regarding issues re-

lated to the area of bank and savings bank supervision,

- active participation in projects at the Croatian National Bank level,
- active participation in inter-institutional projects (in the areas related to money laundering and fighting terrorism),
- intensifying activities aimed at employees' professional training.

## Employees' Training

For the purpose of the continuous training of all the employees of the Area, there were intensified efforts in 2001 aimed at internal training within the Bank Supervision Area; professional training was also provided in co-operation with other organizational units of the Croatian National Bank. In 2001, Bank Supervision Area employees attended various seminars and other forms of training in the country (organized by reputable Croatian institutions in the area of banking and finance) and abroad (organized by BIS, Financial Stability Institute, IMF, JVI, Ministry for the European Integration and several European central banks). In addition, 11 employees of the Area were provided with professional training in the United States.

The intensity of activities and the dynamics of the further development of the supervisory function largely depend on the available resources but also on general conditions in the environment, particularly the ability to apply the new regulatory framework modeled on that in the developed countries.

### 3.8.3 Guidelines for Supervisory Function Development

Prudential bank supervision is not the only pillar of banking system financial stability and it cannot be expected to perform the tasks that are within the authority and jurisdiction of other bodies (management and supervisory boards), other companies (auditing companies) and institutions (courts, etc.). However, we believe that further efforts are required concerning its development so that it could become a source of stability for the other pillars on which the banking system stability rests.

The further development and strengthening of prudential bank supervision is one of the Croatian National Bank's long-term strategic goals. The guidelines for the development of the supervisory function in the near future are the following:

- regulatory improvement, i.e. enactment of the new subordinate legislation pursuant to the new Banking Law;
- continuation of efforts to issue written rules and procedures;
- performing supervision on the consolidated basis;
- strengthening co-operation with other financial supervisory authorities;

- ❑ strengthening co-operation with foreign supervisory authorities;
- ❑ strengthening co-operation with external bank auditors;
- ❑ continuous training of employees;
- ❑ strengthening bank operation transparency.

## 3.9 Riječka banka d.d., Rijeka

Following the resolution of the second banking crisis, the banking system of the Republic of Croatia has consolidated and strengthened considerably over the past few years, regaining public confidence.

In contrast to inadequate credit risk management as the most frequent cause of bank problems, fraud in foreign exchange operations, i.e. in activities related to international market transactions, was the cause of problems in Riječka banka d.d., Rijeka (hereinafter: the Bank). This was the first time that operational risk, i.e. the risk of fraud, had caused problems in a Croatian bank.

This case differs from the others not only in the cause of the operational problems but also in the promptness with which measures were taken to stabilize the Bank's condition.

### 3.9.1 Bank Operation

Following its rehabilitation, the Bank was privatized in June 2000 through international tender. Bayerische Landesbank Girozentrale of Munich became the majority shareholder with 59.9% of the share capital, the State Agency for Deposit Insurance and Bank Rehabilitation retained 25.1%, and other shareholders retained the remaining 15%. Bayerische Landesbank Girozentrale was interested in expanding its operation in the banking market of the Republic of Croatia.

The Bank is licensed to perform all types of banking operations and belongs to the group of larger banks with a usual organizational structure. According to the functional principal, i.e. the operations that it performs, it is divided into areas whose managing directors are responsible for their work to the Bank's management board (hereinafter: Management Board).

With the approval of the Supervisory Board, the Bank adopted several by-laws regulating its operation. Special rulebooks define the methods, authorizations and procedures for individual activities. Additionally, the Bank adjusted its operation to the ISO 9001 quality system.

Over the last three years, the Bank has continuously participated in activities aimed at increasing its market share by improving and expanding the quality and volume of its services and by expanding its operating network. At the same time, the Bank has improved its credit risk management, channeling funds into safer placements in order to reduce repayment risk. A large amount of funds was thus placed in liquidity reserves, i.e. high quality short-term securities: Ministry of Finance treasury bills and CNB bills. According to the received data, the Bank's performance was stable and profitable, and there were no specific indications of any problems or any irregular or illegal activities. The fraudulent activities, as will be shown later, were deftly covered up in the book-keeping records.

The examinations and control of the Bank's overall performance were carried out for different purposes. Foreign consultants (Deloitte Touche, HSBC and Norton Rose) were engaged in the privatization project and the sale of the Bank through international tender, and detailed joint and individual controls (due diligence) were performed, ensuring potential buyers the conditions for obtaining data on the Bank's operations. Until 1999, the Bank's financial reports were audited by PWC; following the entry of the new owner, a new audit company was appointed – KPMG. The internal control and audit performed regular, special and additional examinations of the Bank's performance.

### 3.9.2 Support to the Bank

In March 1999, the Croatian National Bank received an anonymous complaint about irregular activities in the Bank's foreign exchange operations.

Since the Croatian National Bank did not have reliable information that fraud had been committed and the complaint implied that the Management Board had not been aware of the existence of possible irregular activities, the CNB notified the Management Board thereof, requesting a written statement from the Board.

The suspicion of fraud was averted since the Management Board reported that it had taken measures for the establishment of the internal control mechanisms and performance monitoring systems. Additionally, for the purpose of control and daily monitoring of transactions, organizational changes were made so that the front office was strictly separated from the back office. Internal control regularly inspected all operations, including operations in the foreign exchange market, but irregular operations were not identified. Nor did the external auditor detect irregular operations.

The Management Board statement was not contested by the external auditor's report drawn up in accordance with the Croatian National Bank's Decision on the Form and Minimum Scope and Content of an Audit and Reports on Audits of Banks, which assessed as appropriate the Bank's internal control system and the form and scope of the internal control task performance, confirming the correctness and systemic and systematic operation of internal audit as well as compliance with the adequate principles and standards.

In mid-2000, the Croatian National Bank carried out an on-site examination of the

Bank's performance. The on-site examination encompassed the following areas: asset quality, earnings, capital, sources of funds and liquidity, the implementation of monetary and foreign exchange policy measures, internal control and audit, and Bank organization. Apart from establishing the need for forming additional specific reserves for potential losses that might arise from exposure to three Bank clients, amounting to HRK 1.6m, and a violation of the maximum exposure to a single borrower, the on-site examination did not identify other material irregular activities. The Bank's Supervisory Board was warned of the inappropriate organization of internal control and internal audit, whereby the operations and authorities of internal control and internal audit overlap, and of the need for the functional and organizational separation of these functions.

In January 2002, the Croatian National Bank received a second anonymous complaint, also related to the Bank's irregular activities in foreign exchange operations. In order to obtain more information, the Croatian National Bank again requested the Management Board to provide a written statement and to re-examine this part of the Bank's operations as well as its internal control systems, after which an on-site examination of the Bank's operation was to take place.

On 8 February 2002, the Bank's Management Board stated that no irregular activities had been identified in the regular and special controls carried out for this purpose, and confirmed that all the transactions in the foreign exchange market were conducted in a regular manner. It also stated that an external audit was in progress that had not detected any irregularities in the foreign exchange operations. In view of the information received, the Management Board had been informed of possible irregular activities and their potential effect on the financial reports, and, if it suspected the existence of irregularities, it should have immediately notified the external auditor.

On 10 March 2002, the Management Board notified the Croatian National Bank that the Bank's internal control had detected fraudulent activities related to foreign exchange market transactions, estimating the losses at between USD 83m and USD 103m. On 12 March 2002, auditors KPMG notified the Croatian National Bank of the withdrawal of their audit report for 2001. On 13 March 2002, the Croatian National Bank was informed that Bayerische Landesbank Girozentrale did not intend to solve the problems in the Bank by recapitalization. When the Bank's problems were announced in the media, households began to withdraw their savings deposits and legal persons began to withdraw part of their deposits.

The Ministry of the Interior launched an investigation to identify the perpetrators, accomplices, motives and methods of these fraudulent activities. Additionally, the Croatian National Bank began a special on-site examination of the Bank's operation in order to determine the scope of the detrimental activities and their effect on the Bank's financial performance.

The Croatian National Bank was immediately engaged in the process of solving the Bank's problems in order to fulfil its primary tasks: maintaining banking system stability and public confidence in the banking system, protecting depositors' interests and protecting the soundness and stability of the banking system.

At first, the Bank managed to settle its obligations with its own liquid funds, but, due to the increasing withdrawal of savings deposits, it was soon forced to turn to secondary sources of liquidity, i.e. that part of the Bank's assets that can be easily converted into cash<sup>7</sup>. The amount of Bank investment in CNB bills and treasury bills had constantly been growing, reaching HRK 1.2bn at the end of 2001. These funds, placed in low-risk government and central bank debt securities, represented the basis for the Bank support.

Since, excluding its fraudulent activities, the Bank was sound and had a quality portfolio, it was allowed early redemption of CNB bills in the amount of HRK 317m to help it overcome the operational difficulties that had arisen. In addition, a short-term liquidity loan of HRK 408m was granted on the basis of pledged securities.

However, there was a continued run on deposits and a continued threat to liquidity. Between 28 February and 19 April 2002, deposits of a total of HRK 2,593m were withdrawn from the Bank, of which HRK 2,135 were household deposits. Therefore, the Bank was allowed to make additional borrowing, if needed, from the Croatian National Bank on the basis of pledged securities, up to the amount of HRK 863.7m.

Following the public announcement of the problems, the Bank was excluded from the Europay international card system, as a result of which the authorization of cards issued by the Bank was suspended. The Croatian National Bank immediately intensified its efforts in providing assistance to the Bank with the result that the Bank, with the support of a Croatian government guarantee, was reintegrated into the international card system. This prevented a possible adverse effect on the overall banking system stability of Croatia.

After the chairman of the Management Board had withdrawn his savings deposit, which additionally undermined public confidence and could have caused even stronger pressures for deposit withdrawal, the Croatian National Bank agreed to appoint its own experts to the new Management Board.

The awareness that the media reports on the Bank might also undermine confidence in other banks encouraged six Croatian banks, members of the Croatian Bank Association, to grant the Bank a syndicated loan of HRK 1.2bn, which sufficed to settle the Bank's liabilities toward the Croatian National Bank.

The majority owner expressed unwillingness to recapitalize the Bank, when discussing possible solutions to the Bank's current problems and future prospects. Therefore an agreement was reached between Bayerische Landesbank Girozentrale and the State Agency for Deposit Insurance and Bank Rehabilitation by which the latter acquired the former's 59.9% share for the symbolic amount of USD 1, thus becoming the owner of 85% of the Bank's shares.

<sup>7</sup> See Chapter 2.2 for details.

Given the circumstances and the threat of systemic risk, the government acted promptly, effectively and in the only way possible when deciding to purchase the share in the Bank. This prompt action by the government prevented the potential adverse effects that, by triggering the deposit insurance mechanism or causing the domino effect, could have undermined confidence in the banks and damaged the government budget.

The government, deeming recapitalization to be necessary for the Bank's future stable and safe performance and taking into account the additional expenses for the government budget that this would incur, decided to sell its shareholding.

The great interest of other banks in purchasing the Bank confirmed that the Bank is sound, when its fraudulent activities are excluded. On the basis of the received bids, the State Agency for Deposit Insurance and Bank Rehabilitation decided to sell its 85% shareholding in the Bank to Erste Bank of Vienna, which offered EUR 55m for the shares and EUR 100m for the recapitalization. This would generate revenues for the government budget, considering the circumstances under which the shares had been acquired.

The Croatian National Bank and the Government of the Republic of Croatia had acted promptly:

- 1) by offering public support to the Bank;
- 2) by providing the required liquid funds for the Bank;
- 3) by promptly settling the ownership relations with the previous owner;
- 4) by appointing the Croatian National Bank's experts to the Management Board; and
- 5) by assisting in the Bank's reintegration into the Europay card system;

The above activities enabled the maintenance of banking system stability and confidence in the banking system, the protection of the interests of the Bank's depositors, and the protection of the soundness and stability of the overall banking system. Due to the co-operation between the Croatian government and the Croatian National Bank and the co-ordination of their activities, the Bank's condition has stabilized.

### 3.9.3 Fraudulent Transactions

Parallel to its active participation in the process of solving the Bank's problems, the Croatian National Bank began an on-site supervision of the Bank's operations on 16 March 2002 with the aim of establishing the real scope of the fraudulent transactions in the foreign exchange market.

#### Foreign Exchange Operations Structure

The Bank had by-laws for the individual parts of its operations that regulated employees' authorities and methods of performing particular tasks, methods of delegating au-

thority, restrictions on particular activities, and quality procedures in accordance with the ISO standard on quality performance.

The operations related to transactions in the foreign exchange market are thus regulated in the appropriate manner. The Bank's by-laws regulate individual authorities and restrictions on performing particular activities, as well as periodical reporting requirements to the Management. For every foreign exchange transaction, the procedure sequence, documentation reference, responsibilities and authorities are in compliance with the ISO procedures.

The foreign exchange transactions are conducted in the Foreign Exchange Market Division, an organizational unit within the Foreign Exchange Asset Department and Asset Management Area.

The Bank's by-laws set out the delegation of the individual authorities of the Area Managing Director and the restrictions in foreign exchange operations on approving short-term foreign exchange deposits, purchasing and selling foreign exchange in domestic and foreign markets, and exchange arbitrage operations in particular. The Director of the Foreign Exchange Asset Department, the Head of the Foreign Exchange Market Division (chief dealer) and employees of the Foreign Exchange Market Division are thus authorized to approve short-term foreign exchange deposits and the purchase and sale of foreign exchange and cash of a value of up to 10% of the Bank's risk-based capital. The Director of the Foreign Exchange Asset Department and the Head of the Foreign Exchange Market Division (chief dealer) are authorized for exchange arbitrage operations of a value of up to 10% of the Bank's risk-based capital, whereas the amount for employees of the Foreign Exchange Market Division may not exceed 2% of the risk-based capital. All these persons are obliged to report to the Area Managing Director on their decisions every 15 days.

A special by-law regulates that the Head of the Foreign Exchange Market Division (chief dealer) performs exchange arbitrage operations under the following restrictions: the Bank's total exposure may at no time exceed USD 50m, and the amount of an individual transaction may not exceed 10% of the risk-based capital in the case of the chief dealer or 2% of the risk-based capital in the case of all other dealers. Additionally, all positions opened during the day must be closed at the end of the same day. An individual dealer is permitted to have, at any time, open positions totaling USD 5m, provided that each individual transaction does not exceed 2% of the risk-based capital.

The Head of the Foreign Exchange Market Division (chief dealer), the Asset Management Area Managing Director, the Foreign Exchange Asset Department Director and the competent Management Board member must at all times have at their disposal the information on the current balance of income and expenditures arising from daily transactions and on bank exposure. Reports on the foreign exchange market operations are presented to the Management Board every 15 days.

The Bank established the ISO quality procedures for the above operations, which determine the procedure sequence, documentation reference, responsibilities and authorities, and procedure details.

## Control and Audit

The Bank's internal control and audit have continuously performed regular, special and additional examinations during which no irregular activities were identified in this part of the Bank's operations.

Internal auditors have regularly expressed their opinion that the Bank's financial reports provide a true and fair account of the Bank's performance.

The on-site examination findings of mid-2000 found the incorrect classification of three clients and made recommendations concerning the organizational and functional separation of internal control from internal audit. Apart from that, it did not report any materially irregular activities in the Bank's performance.

## Current On-Site Examination Findings Related to the Fraudulent Activities

A few days following the start of the on-site examination, it was clear that the entire procedure for determining the real financial position of the Bank would be prolonged and difficult. It was found that the prescribed procedures for foreign exchange operations were inconsistently applied and that there was a lack of procedure compliance control. This had created room for possible fraud, which had been systematically committed over several years. The fraud had been deftly covered up by forged documentation and facilitated by the inconsistent application of the envisaged control procedures.

The Bank's chief dealer had engaged in detrimental activities related to transactions in international money and capital markets, and exchange arbitrage in particular. In order to clarify these fraudulent activities, a short overview of the method of conducting these transactions follows.

In addition to the standard operations of making foreign exchange time deposits, and purchasing and selling foreign exchange cash and other operations related to its foreign exchange position, the Bank performs exchange arbitrage in the foreign exchange market. Exchange arbitrage may be non-risky or risky, i.e. speculative.

Non-risky exchange arbitrage includes foreign exchange purchasing and selling operations with smaller Croatian banks that do not have access to international foreign exchange markets and thus perform these operations through the Bank. For example, a smaller bank wants to buy German marks from the Bank in exchange for US dollars. The Bank then contacts a foreign bank, buys German marks for US dollars, and sells these German marks to the former bank for its US dollars at a rate that is more favorable for the Bank. The Bank then closes its position and earns a profit. These are relatively tight-margin transactions, and losses cannot be incurred in general.

Risky (speculative) exchange arbitrage includes transactions in which one currency, e.g. X, is purchased for another currency, e.g. Y, in the expectation that the value of currency X, measured in currency Y units, will rise, and that currency X will be sold during the day, earning a certain profit. For example, a dealer decides to buy USD 1m and

pays DEM 2m for them (exchange rate: USD/DEM 2.00). The exchange rate increases to DEM 2.05 for USD 1 during the day, and the dealer decides to sell USD 1m, which is now worth DEM 2.05m. The dealer thus earns DEM 0.05m as a result of a favorable change in the USD/DEM exchange rate. The transaction technology is identical to non-risky arbitrage, apart from a single difference – the dealer does not have a bank on the other side to which he will sell the purchased currency at a definitely more favorable exchange rate but rather speculates that the exchange rate will move in the desired direction during the day and that he will close out the open position with a profit. Accordingly, in risky differential arbitrage there is the possibility of both profit and loss.

Additionally, if a dealer, when opening a position, buys dollars for marks from one bank, he is not obliged to close the position, i.e. to sell dollars for marks, with the same bank but may do this with another bank.

The Bank's chief dealer, trying to earn a profit in foreign exchange markets, incurred losses that were not entered in the Bank's bookkeeping records. The losses were covered up in several ways:

- ❑ by unauthorized borrowing of funds in the form of received deposits from foreign banks,
- ❑ by recording nonexistent deposits in bank assets,
- ❑ by contracting exchange arbitrage and not fulfilling the obligations arising from them,
- ❑ by recording exchange arbitrage at an incorrect value date.

The chief dealer, contrary to every business practice in foreign exchange markets, simultaneously traded, engaged in transfers of funds through SWIFT, and ordered false or incorrect entry of these transactions in the accounting records.

The exact amount of losses incurred from his transactions will be determined only when details of all the transactions entered in the Bank's accounting records are established, starting from overvalued foreign deposits in assets, a large number of borrowed deposits that were not recorded in the bank's liabilities, and a large number of transactions in which the Bank's chief dealer purchased and sold one currency for another without fully reporting to the Bank about them.

The investigation carried out by the Bank revealed that all the suspicious transactions were conducted in the back office and with the same password.

Complaints about the Bank's unsettled obligations were frequently received, but no adequate action was taken. The SWIFT messages containing complaints or that were for any reason unclear to the back office/accounting department employees were forwarded for clarification to the chief dealer.

According to the currently available data, a total loss of USD 98m was incurred in the described transactions:

- ❑ a loss of USD 38.95m in artificial, nonexistent deposits;
- ❑ a loss of USD 23.6m in borrowed deposits of which no-one had any knowledge;
- ❑ a loss of USD 9.9m in open foreign exchange transactions;
- ❑ a loss of USD 1.17m in two margin accounts,
- ❑ a loss of USD 24.3m in 5 open foreign exchange arbitrages.

The chief dealer's knowledge of the internal control and reporting system in the Bank allowed him to perform operations that were incorrectly recorded and which exposed the Bank to high risks. The incurred losses were covered up by failure to enter or false entry in the Bank's bookkeeping records and financial reports, as a consequence of the inadequate implementation of the envisaged control mechanisms.

These are criminal activities that caused serious losses for the Bank. Unfortunately, the Bank's owner was unwilling to recapitalize the Bank and so this problem could not be solved "silently", as is common practice in the banking world in order to reduce the potential adverse effects on banking system stability. However, the Croatian government and the Croatian National Bank took prompt measures, curbing the downward trends and allowing the Bank's condition to stabilize, which prevented the problem from spreading. In addition, the problem was solved in a way that incurred no additional expenses for the government budget and also protected the Bank's depositors.

The investigation into the fraudulent activities is continuing: on the part of the Ministry of the Interior in order to identify the real perpetrators, accomplices, motives and methods of the criminal acts, and on the part of the Croatian National Bank in order to determine the scope of these detrimental activities and their impact on the Bank's financial performance.