

CROATIAN NATIONAL BANK

2002

ANNUAL REPORT

# 3

## Banking System of the Republic of Croatia

## 3.1 Characteristics of the Banking System

Although all 46 licensed banks had a bank operating license, 5 of them are obliged to increase their share capital. Pursuant to the provisions of the new Banking Act, which came into force in mid-2002, banks are required to have HRK 40m of share capital in order to obtain a bank operating license. The transitional and final provisions of the Banking Act stipulate that by end-2006 savings banks have to gradually increase the level of their share capital.

During 2002 (Table 3.1), 7 savings banks entered the system of commercial banks since they increased their share capital to HRK 20m, and thus met the current Banking Act conditions for registering as banks<sup>1</sup>, whereas three banks merged with other banks, and a foreign bank branch ceased to exist<sup>2</sup>. Hence, the number of banks grew from 43 at end-2001 to 46 at end-2002. The number of savings banks and housing savings banks fell from 19 at the end of 2001 to 4 at the end of 2002. This was the result of the transformation of 7 savings banks into banks, initiation of liquidation proceedings in 3 sav-

Table 3.1 Changes in the Number of Banking Institutions

Banks	2000	2001	2002
Number of banks at the beginning of the year	53	43	43
Former savings banks that were granted bank license	–	+1	+7
Banks that merged with other banks	–4	–	–3
Banks undergoing bankruptcy proceedings	–4	–	–
Banks whose license was revoked	–1	–1	–
Banks that failed to comply with the Banking Act	–1	–	–
Foreign bank branch removed from the register	–	–	–1
Number of banks at the end of the year	43	43	46
Savings banks and housing savings banks	2000	2001	2002
Number of savings banks at the beginning of the year	34	26	19
Savings banks transformed into banks	–	–1	–7
Savings banks that merged with other banks/savings banks	–	–2	–4
Savings banks undergoing liquidation	–	–2	–3
Savings banks undergoing bankruptcy proceedings	–1	–	–1
Savings banks whose license was revoked	–7	–2	–
Number of savings banks and housing savings banks at the end of the year	26	19	4

<sup>1</sup> Banka Sonic d.d., Zagreb; Prva obrtnička banka d.d., Zagreb; Banka Kovanica d.d., Varaždin; Banka Brod d.d., Slavonski Brod; Križevačka banka d.d., Križevci; Zagorska banka d.d., Krapina and Splitsko-dalmatinska banka d.d., Split.

<sup>2</sup> Istarska banka d.d., Pula and Sisačka banka d.d., Sisak merged with Dalmatinska banka d.d., Zadar, and are now operating as Nova banka d.d., Zagreb; Prva obrtnička banka d.d., Zagreb merged with Hypobanka d.d., Zagreb, and now operates as Primus banka d.d., Zagreb; Bayerische Hypo- und Vereinsbank AG, Glavna podružnica Zagreb was removed from the register of the commercial court in Zagreb.

ings banks and bankruptcy proceedings in one savings bank, and a merger of 3 savings banks and 1 housing savings bank with other banking institutions.

In the reporting three-year period, the share of banks in majority foreign ownership in total bank assets continually rose, whereas the share of banks in majority domestic ownership declined (Table 3.2). The number of banks in majority private ownership of domestic shareholders rose from 16 to 21 due to the transformation of savings banks into banks, and their share in total assets slightly grew. The number of banks in state ownership and their share in total bank assets declined because Dubrovačka banka d.d., Dubrovnik has become a bank in foreign ownership.

Table 3.2 Ownership Structure of Banks

Ownership structure	Number of banks			Share of assets in total bank assets		
	2000	2001	2002	2000	2001	2002
Banks in total or majority private ownership of domestic shareholders	20	16	21	10.2	5.6	5.8
Banks in total or majority state ownership	3	3	2	5.7	5.0	4.0
Banks in total or majority foreign ownership	20	24	23	84.1	89.3	90.2
Total	43	43	46	100.0	100.0	100.0

Table 3.3 shows the number of banks in peer groups of banks classified by asset size and the share of each group in total assets. The number of banks with assets exceeding HRK 5bn (Group I) increased from 6 to 9 in 2002, whereas their share in total assets grew from 70.7% in 2001 to 79.6% in 2002<sup>3</sup>. The number of banks with assets from HRK 1bn to 5bn (Group II) fell from 14 to 12 in 2002, and the share of this group in total assets fell from 23.1% to 15.2%<sup>4</sup>. Groups III and IV (totaling 25 banks) comprising banks with assets below HRK 1bn and HRK 0.5bn respectively, together accounted for only 5.2% of total bank assets at-end 2002. Group I encompasses banks with very different asset size, with assets of the two largest banks far above that of other Group I banks. By contrast, Group II banks are more homogenous in terms of asset size. Group III consists of similar small banks and Group IV comprises small banks of different size, of which 6 were formerly savings banks.

The banking system consolidation process continued in 2002, and market concentration declined. Three banking groups accounted for 57.9% of total assets at end-2001, whereas 6 banking groups accounted for 79.5% of total assets at the banking system level at end-2002. All these groups are in majority foreign ownership. Competition among banks and banking groups has been rising, as is clearly visible in the continued decline in interest rates.

The events in Riječka banka d.d., Rijeka marked the banking system in 2002. Established losses of Riječka banka, which were generated in 2001 and several previous

<sup>3</sup> This group includes Zagrebačka banka d.d., Zagreb; Privredna banka Zagreb d.d., Zagreb; Raiffeisenbank Austria d.d., Zagreb; Splitska banka d.d., Split; Riječka banka d.d., Rijeka and Hypo Alpe-Adria-Bank d.d., Zagreb. Erste & Steiermaerkische Bank d.d., Zagreb; Hrvatska poštanska banka d.d., Zagreb and Nova banka d.d., Zagreb joined this group in 2002.

<sup>4</sup> Erste & Steiermaerkische Bank d.d., Zagreb; Hrvatska poštanska banka d.d., Zagreb and Istarska banka d.d., Pula, which merged with Dalmatinska banka d.d., Zadar (i.e. Nova banka d.d., Zagreb) joined Group I in 2002, whereas Podravska banka d.d., Koprivnica and Dresdner Bank Croatia d.d., Zagreb joined Group II.

Table 3.3 Number of Banks by Asset Size  
in million HRK and %

Assets		Number of banks			Share of assets in total bank assets		
		2000	2001	2002	2000	2001	2002
Group I	Assets exceeding 5,000	5	6	9	66.3	70.7	79.6
Group II	Assets from 1,000 to 5,000	13	14	12	25.5	23.1	15.2
Group III	Assets from 500 to 1,000	8	7	7	4.6	3.3	2.7
Group IV	Assets below 500	17	16	18	3.6	2.9	2.5
Total		43	43	46	100.0	100.0	100.0

years, are shown in its audited reports for 2001. A detailed account of these events is given in the CNB Annual Report for 2001.

The new Banking Act, which came into force in July 2002, is adjusted to the EU regulations in all essential elements. Pursuant to this act, early 2003 saw the enforcement of prudential decisions that regulate the method of classifying placements and contingent liabilities, the capital adequacy and currency risk management. These decisions were joined by the decisions related to the organization and method of performing bank examination, which stipulate in detail the method of supervising bank operations, consolidated supervision of banking groups and the scope and content of the audit of financial reports. In addition, the decision defining in detail the methods and procedures for protecting the freedom of market competition and the new decision regulating operations of a foreign bank's representative office also came into force. The following decisions are currently being prepared: the decision regulating liquidity management, the decision regulating the application of the Banking Act on banks undergoing liquidation and the one stipulating the conditions for the establishment and operation of foreign bank branches. Due to the complexity of these issues, especially in the part relating to market risk management, the transitional and final provisions of these prudential decisions stipulate that most of their provisions are to be applied as of 1 January 2004. Hence, the effects of the new prudential regulations will not be fully visible until that year.

## 3.2 The Balance Sheet Structure of the Banks

### 3.2.1 Bank Asset Structure

Total bank assets amounted to HRK 174.4bn<sup>5</sup> at end-2002, which is a 17.5% increase over that at the end of 2001 when it stood at HRK 148.4bn (Table 3.4). This increase was mostly the result of the rise in net loans to other clients (non-banking sector), which stood at HRK 90.1bn at end-2002, HRK 25.7bn or 40% over that at end-2001. To finance this increase banks mostly used funds resulting from the deposit growth and loans received. The share of loans to other clients in the structure of bank assets rose from 43.4% at end-2001 to 51.7% at end-2002.

<sup>5</sup> All financial data is based on preliminary unaudited bank reports for 2002.

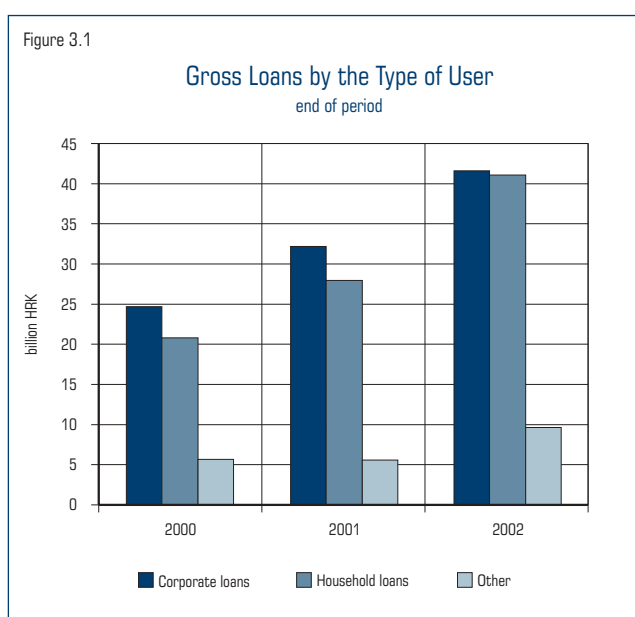
Table 3.4 Structure of Bank Assets  
end of period, in million HRK and %

	2000			2001			2002		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Money assets and deposits with the CNB	11,489.3	10.3	18.0	22,196.3	15.0	93.2	21,388.0	12.3	-3.6
1.1. Money assets	1,506.3	1.3	20.9	7,822.5	5.3	419.3	2,236.9	1.3	-71.4
1.2. Deposits	9,983.1	8.9	17.6	14,373.9	9.7	44.0	19,151.1	11.0	33.2
2. Deposits with banking institutions	17,695.3	15.8	71.6	23,900.1	16.1	35.1	20,152.5	11.6	-15.7
3. MoF treasury bills and CNB bills	6,059.0	5.4	93.0	9,687.2	6.5	59.9	9,746.2	5.6	0.6
4. Trading portfolio of securities	2,462.4	2.2	130.6	4,795.6	3.2	94.8	8,448.6	4.8	76.2
5. Loans to financial institutions	1,085.6	1.0	-12.9	1,479.6	1.0	36.3	2,152.9	1.2	45.5
6. Loans to other clients	50,130.7	44.8	10.4	64,402.5	43.4	28.5	90,177.4	51.7	40.0
7. Investment portfolio of securities	14,167.5	12.7	-8.5	12,741.3	8.6	-10.1	12,656.3	7.3	-0.7
8. Investments in subsidiaries and associates	2,411.0	2.2	36.3	2,199.8	1.5	-8.8	2,424.2	1.4	10.2
9. Foreclosed and repossessed assets	614.5	0.5	37.4	446.8	0.3	-27.3	377.0	0.2	-15.6
10. Tangible assets and software (net of depreciation)	3,252.5	2.9	2.8	3,501.2	2.4	7.6	3,765.4	2.2	7.5
11. Interest, fees and other assets	3,169.2	2.8	25.9	4,273.5	2.9	34.8	4,633.7	2.7	8.4
12. Net of: Specific reserves for unidentified losses	699.4	0.6	-6.0	1,195.7	0.8	71.0	1,517.9	0.9	27.0
Total	111,837.7	100.0	19.6	148,428.3	100.0	32.7	174,404.2	100.0	17.5

Loan growth ranging between 20.0% and 62.0% was recorded in 25 banks. 6 banks, whose share in total bank assets stood at 68.7% at end-2002, accounted for 75.4% of the nominal increase in total loans, whereas 4 leading banks, with a 58.1% share in total bank assets, accounted for 66.5% of the total nominal loan growth. Only three banks recorded a decline in loans.

Figure 3.1, which shows gross loans by the type of user, indicates that the strong credit activity related to households, which started in the previous years, continued into 2002.

Gross household loans amounted to HRK 41.1bn in 2002. By opening new operating units for retail banking, the banks strove to improve their position in the segment of the credit market that is of their increasing interest - the household sector. Large banks led the way, as evident from Figure 3.2, which shows the sectoral structure of loans by 4 peer groups of banks classified by asset size. Household loans predominated in Group I (9 large banks), accounting for 44.7% of total loans granted by this group. 6 banks in this group increased the share of household loans, whereas two of them changed their business strategy and directed most of their operations towards retail banking. Corporate loans predominated in other bank groups, especially Group III, in which they accounted for 58.53% of total loans granted. The influence of this group on the system is negligible. However, owing to the developments in large banks (Group I), the share of household



loans almost reached the share of corporate loans at the banking system level in late 2002. The share of other loans (loans to financial institutions, the public sector, non-profit institutions and non-residents) accounted for 11.3% of total loans granted by Group I banks. One of these banks, which is in majority state ownership, accounted for 45% of total loans granted to the public sector in 2002. The share of other loans in total loans granted by Group II banks stood at 9.4% at-end 2002, whereas these loans were insignificant in Groups III and IV.

Table 3.4 shows that deposits with banking institutions decreased by 15.7% in 2002 compared with end-2001, and their share in assets was 11.6%, or significantly less than at end-2001 (16.1%). This decrease resulted from the reallocation of these funds into loans. Following a record high growth in 2001, induced by the inflow of funds for the purpose of the euro conversion, money assets of banks recorded a strong decline in 2002. In contrast, deposits with the CNB continued on their strong upward trend (they rose by 33.2% compared with 2001, and their share grew from 9.7% to 11.0%). This was triggered by the increase in reserve requirements allocated with the CNB, as well as the rise in balances in the settlement accounts. Investments in Ministry of Finance treasury bills and CNB bills recorded a much slower growth trend than in the previous periods, while the investment portfolio of securities recorded a slight fall, both in nominal terms and in terms of its share in total assets. The trading portfolio of securities rose by 76.2% in 2002, remaining on a relatively fast growing trend. In 2002, the banks mostly traded in bonds issued by the Republic of Croatia, as well as bonds issued by foreign countries and financial institutions.

### 3.2.2 Bank Liability Structure

Deposits predominate in the bank liability structure. At end-2002, they accounted for 71.4% of total liabilities, which is somewhat over that at end-2001 (70.5%) (Table 3.5). This share and its trend were influenced by 9 large banks in Group I whose deposits accounted for 72.3% of total liabilities. The deposits with other bank groups had a somewhat lesser share in total liabilities, as illustrated by Figure 3.3, total deposit growth amounted to HRK 19.7bn, while total credit growth was higher, HRK 26.4bn. 90.7% of the total nominal increase in deposits was accounted for by 6 large banks, whose share in total liabilities and total deposits stood at 64.3% and 71% respectively. Owing to the decline in deposits, which grew at end-2001 due to the euro conversion, as well as the drop in deposits with Riječka banka d.d., Rijeka, deposit growth was much more moderate in the first half of 2002 than in the second half of the year. The increase of HRK 15.5bn or 25% was recorded by time deposits, of which those of foreign financial institutions grew the most. They were followed by household time deposits. Giro and current account deposits also recorded a strong growth (HRK 6.7bn or 40.6%), of which giro and current account deposits of other companies grew the most.

Figure 3.2

Sectoral Structure of Loans by Peer Groups of Banks end-2002

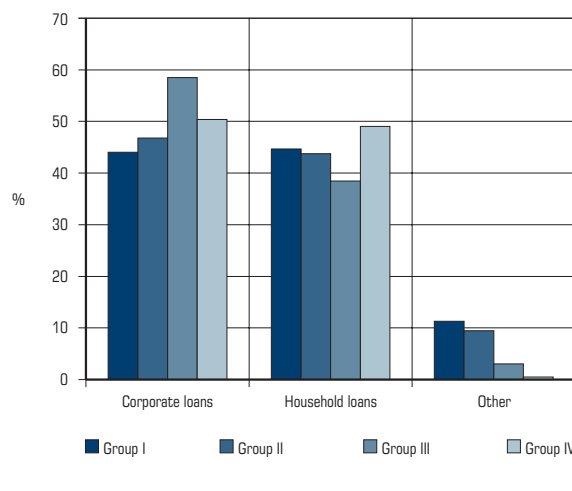


Table 3.5 Structure of Bank Liabilities  
end of period, in million HRK and %

	2000			2001			2002		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Loans from financial institutions	3,510.9	3.1	-33.5	3,629.1	2.4	3.4	4,084.8	2.3	12.6
1.1. Short-term loans	1,130.8	1.0	-45.9	595.7	0.4	-47.3	1,184.4	0.7	98.8
1.2. Long-term loans	2,380.1	2.1	-25.5	3,033.3	2.0	27.4	2,900.4	1.7	-4.4
2. Deposits	72,683.4	65.0	27.5	104,697.2	70.5	44.0	124,475.4	71.4	18.9
2.1. Giro account and current account deposits	12,619.0	11.3	36.9	16,548.6	11.1	31.1	23,272.2	13.3	40.6
2.2. Savings deposits	17,689.3	15.8	29.3	26,373.9	17.8	49.1	23,981.1	13.8	-9.1
2.3. Time deposits	42,375.1	37.9	24.3	61,774.6	41.6	45.8	77,222.0	44.3	25.0
3. Other loans	16,329.0	14.6	8.8	15,947.7	10.7	-2.3	19,492.9	11.2	22.2
3.1. Short-term loans	503.3	0.4	-69.6	594.0	0.4	18.0	4,451.5	2.6	649.4
3.2. Long-term loans	15,825.7	14.2	18.5	15,353.7	10.3	-3.0	15,041.4	8.6	-2.0
4. Debt securities issued	0.0	0.0	-	19.4	0.0	-	24.7	0.0	27.4
4.1. Short-term debt securities issued	0.0	0.0	-	0.0	0.0	-	5.1	0.0	-
4.2. Long-term debt securities issued	0.0	0.0	-	19.4	0.0	-	19.6	0.0	1.0
5. Supplementary capital	520.3	0.5	51.7	2,655.8	1.8	410.4	2,909.9	1.7	9.6
5.1. Subordinated instruments issued	282.9	0.3	168.08	339.4	0.2	20.0	641.3	0.4	89.0
5.2. Hybrid instruments issued	237.4	0.2	0.0	2,316.4	1.6	875.7	2,268.6	1.3	-2.1
6. Interest, fees and other liabilities	5,475.5	4.9	12.9	7,783.0	5.2	42.1	6,642.4	3.8	-14.7
7. Profit/loss for the current year	1,123.2	1.0	140.8	570.0	0.4	-49.3	2,188.6	1.3	284.0
8. Capital	12,195.5	10.9	15.3	13,126.3	8.8	7.6	14,585.6	8.4	11.1
Total	111,837.7	100.0	19.6	148,428.3	100.0	32.7	174,404.2	100.0	17.5

Owing to a steeper growth in deposits of financial institutions and companies, the share of household deposits in total deposits fell from 68.4% to 58.4%. As in the previous years, the majority of deposits were denominated in foreign currency (70.6%).

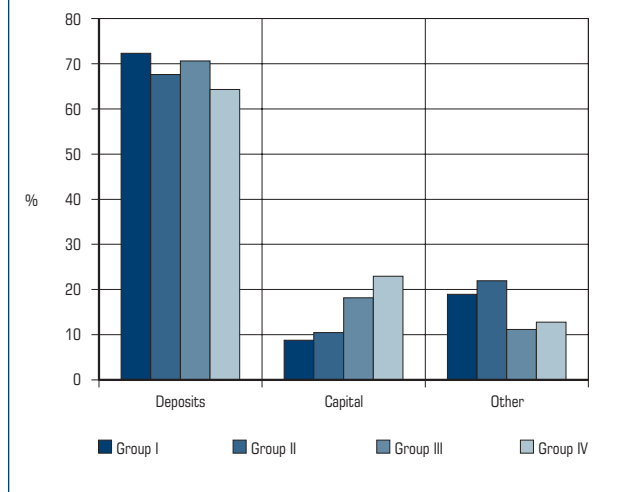
Received loans accounted for the second largest share in the liability structure. In 2002, other loans received rose by 22.2% in nominal terms compared with end-2001, whereas loans from financial institutions grew by 12.6% (Table 3.5). Total received

loans (loans from financial institutions and other loans) in the liability structure rose from 13.1% at end-2001 to 13.5% at end-2002. The largest share in total received loans was accounted for by loans from foreign financial institutions (71.0%), which were followed by CBRD loans (11.5%). 76.1% of total received loans had maturities longer than 1 year.

The liability structure by peer groups of banks (Figure 3.3) shows that 12 banks in Group II used other sources the most (21.9%), followed by Group I banks, which used 18.9% of total other sources. Figure 3.3 also shows that capital (together with profit for the current year) accounted for the smallest share in the liability structure of large banks in Group I (8.7%), while it accounted for as much as 22.9% in Group IV banks. Small banks, which account for a negligible share in the

Figure 3.3

### Liability Structure by Peer Groups of Banks end - 2002



banking market, use more capital to compensate for their poorer access to other sources of funds.

## 3.3 Bank Capital

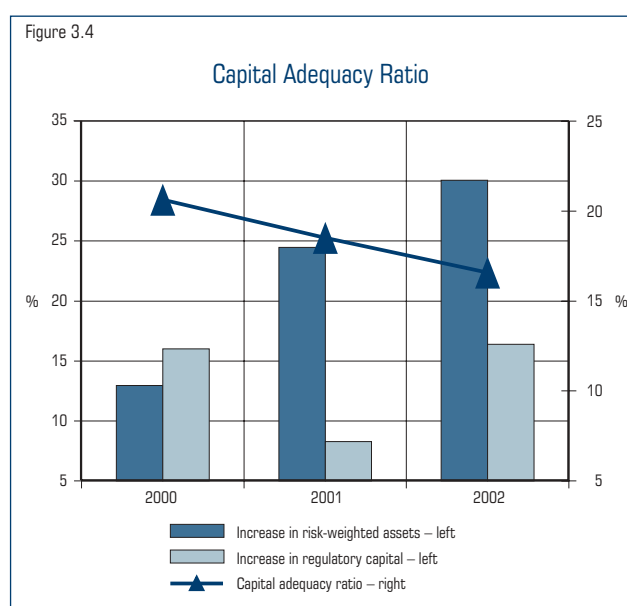
At the end of 2002, bank capital amounted to HRK 14.5bn, an 11.1% rise compared to 2001 (Table 3.6). This was mostly the result of the increase in share capital and retained income. In the observed period, share capital rose by HRK 509.2m or 8.7% in nominal terms. Four, mostly large banks, accounted for 65.2% of the total increase in share capital. The share of this capital in total capital decreased, whereas the share of retained income grew. Compared with 2001, retained income grew by HRK 782.5m, and was as much as 10 times over that at end-2001. Reserves (legal reserves, reserves provided for by the articles of association and other reserves) were on a downward trend, both in nominal terms and in terms of their share in capital. Capital and profit for the current year together rose by 22.5% in 2002.

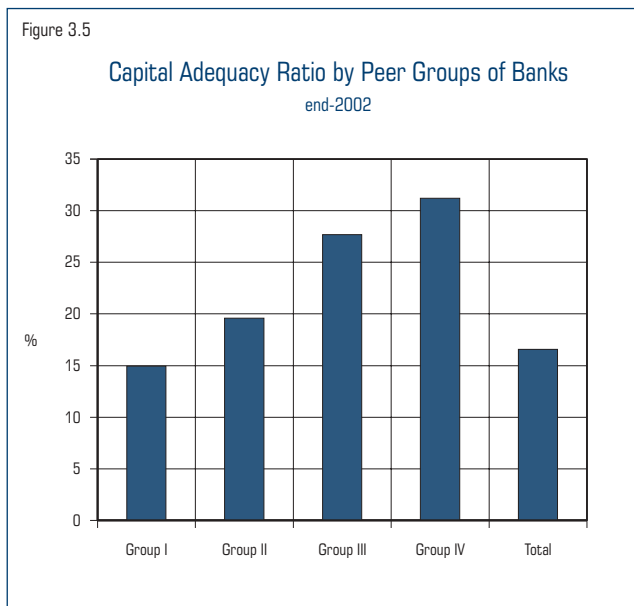
**Table 3.6 Structure of Bank Capital**  
end of period, in million HRK and %

	2000		2001			2002		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
1. Share capital	8,549.9	70.1	8,966.5	68.3	4.9	9,747.3	66.8	8.7
2. Retained income/loss	326.2	2.7	77.8	0.6	-76.2	860.3	5.9	1,006.0
3. Legal reserves	2,098.8	17.2	853.3	6.5	-59.3	582.9	4.0	-31.7
4. Reserves provided for by the articles of association and other capital reserves	1,220.5	10.0	3,228.7	24.6	164.5	3,395.1	23.3	5.2
Total	12,195.5	100.0	13,126.3	100.0	2.8	14,585.6	100.0	11.1

Regulatory capital is a calculation category to measure a bank's ability to cover unexpected losses. At end-2002, the regulatory capital of banks amounted to HRK 16.2bn, which is a 16.4% increase over that at end-2001 when it stood at HRK 13.9bn. Supplementary capital, which is included in regulatory capital, accounted for 18.4% of gross regulatory capital. It grew nominally by 33.3% in 2002 as compared to end-2001, mostly due to the rise in specific reserves for unidentified losses and an upturn in subordinated instruments.

The capital adequacy ratio of banks (regulatory capital to risk-weighted assets ratio) amounted to 16.6% at end-2002, which is less than at end-2001 when it stood at 18.5%. At end-2002, all banks reported capital adequacy above the minimum prescribed ratio of 10%. The downward trend in the capital adequacy ratio, which was recorded over the last





three years, resulted from a faster growth in risk-weighted assets than in risk-weighted capital (Figure 3.4). Large banks in Group I whose capital adequacy ratio stood at 14.9% at end-2002 influenced these developments in capital adequacy, while other bank groups recorded higher capital adequacy ratio (Figure 3.5). The decline capital adequacy to cover credit risk has been observed for some time, which has brought the balance sheet structure of large domestic banks closer to that of Western European banks. As already stated, since smaller banks compensate for their poorer access to other sources of funds by maintaining higher levels of capital, their capital adequacy is far above the minimum prescribed ratio. This was also influenced by the increase in capital of former savings banks to meet the conditions for registering as banks.

## 3.4 Bank Asset Quality

The asset quality assessment is based on International Accounting Standard 39. In the assessment, banks are obliged to adopt and implement their internal placement classification systems, as prescribed by the decisions enacted under the former Banking Act<sup>6</sup>, which were applicable in 2002. The Decision on the Classification of Placements and Contingent Liabilities of Banks, which was adopted pursuant to the new Banking Act, contains similar provisions.

Bank placements (including off-balance sheet items) are first classified into three main categories and then into risk groups, depending on the degree of risk.

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 (groups A and B). These placements are not subject to value impairment. The second category encompasses partly recoverable placements (groups C and D). These placements involve impairment loss corresponding to the difference between the asset's carrying amount and its recoverable amount, which equals the present value of expected future cash flows arising from these placements. The third category (group E) includes placements whose present value equals zero (irrecoverable placements).

Impairment loss on partly recoverable placements and irrecoverable placements represents bank expenses of the amount by which the asset items are reduced and strongly

<sup>6</sup> The Decision on the Classification of Placements and Risky Off-Balance Sheet Items and Assessment of Bank Exposure, the Decision on the Amount and Method of Forming Specific Reserves to Ensure Against Potential Losses of Banks, and the Decision on the Method of Improving the Compliance of the Croatian National Bank Subordinate Legislation with the International Accounting Standards.

affect bank performance. Although placements graded A and B are not subject to individual impairment, banks are obliged to form reserves 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 group B, banks are obliged to form reserves according to their policy.

At the end of 2002, fully recoverable placements (groups A and B) grew by 22.5% compared to 2001 and accounted for 94.2% of total risk assets (Table 3.7). Partly recoverable placements (groups C and D) and placements whose present value equals zero (group E) accounted for 3.5% and 2.3% respectively of total risk assets. The two latter groups of placements recorded a decrease, both in nominal terms and in terms of their share in total placements. As shown in Table 3.8, total impairment (placements reduced by the amount of established losses arising from partly recoverable and irrecoverable placements together with reserves for unidentified losses) amounted to HRK 9bn at-end 2002, which is somewhat less than at end-2001. The share of total impairment in total placements had a strong downward trend: it was 8.2% in 2000, 6.2% in 2001, and 5% at end-2002 (Table 3.8). This downward trend in total impairment, both in its absolute amount and relative to total placements, resulted from an increase in the share of groups A and B. This is supported by the structure of total impairment: while placement reduction by the amount of established losses arising from partly recoverable and irrecoverable placements 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.

**Table 3.7 Classification of Bank Placements by Risk Groups**  
end of period, in million HRK and %

Placements	2000		2001		2002	
	Amount	Share	Amount	Share	Amount	Share
1. Fully recoverable placements	112,198.3	90.5	140,586.6	92.7	172,165.5	94.2
1.1. Group A	108,489.8	87.5	137,195.6	90.5	168,584.7	92.2
1.2. Group B	3,708.5	3.0	3,391.0	2.2	3,580.9	2.0
2. Partly recoverable placements	6,923.1	5.6	6,719.5	4.4	6,386.1	3.5
2.1. Group C	3,090.3	2.5	3,193.3	2.1	3,649.4	2.0
2.2. Group D	3,832.8	3.1	3,526.2	2.3	2,736.7	1.5
3. Irrecoverable placements	4,803.1	3.9	4,287.3	2.8	4,270.0	2.3
3.1. Group E	4,803.1	3.9	4,287.3	2.8	4,270.0	2.3
Total	123,924.5	100.0	151,593.3	100.0	182,821.6	100.0

**Table 3.8 Total Provision to Total Placement Ratio of Banks**  
end of period, in million HRK and %

	2000	2001	2002
1. Total provisions for losses	10,176.6	9,326.7	9,072.8
1.1. Placement value impairment (loss)	9,355.4	7,912.1	7,258.3
1.2. Provisions for unidentified losses	821.2	1,414.6	1,814.5
2. Total placements	123,924.5	151,593.3	182,821.6
3. Relative ratio of total provisions to total placements	8.2	6.2	5.0

Strong growth in household loans continued in 2002. Household debt is still relatively low in the Republic of Croatia according to international measures. Household debt to GDP ratio is around 50% in developed countries, while it was 23.3% in Croatia at the end of 2002. However, the unemployment rate, which has been over 20% in the last 3 years and data on the nominal slowdown in the net wage growth darken the picture of the good financial position of the household sector. Strong credit growth was not accompanied by the rise in the share of bad placements and provisions relative to total placements. Owing to a potential increase in provision expenses, too rapid credit activity may adversely affect bank profitability in the future. Hence, in early 2003, the Croatian National Bank adopted a decision prescribing the obligatory purchase of CNB bills for banks with high credit growth (of over 16% a year). In addition, the new Decision on the Classification of Placements and Contingent Liabilities of Banks prescribes the formation of additional reserves for general bank risks that may arise as a result of a rapid growth in bank balance sheet and off-balance sheet activities and, as a consequence, increased bank exposure to various types of risks. The provisions of this decision will be applied in preparing annual reports for 2003.

### 3.4.1 Prescribed Limitations on Exposure and Extent of Investments

To protect the stability of bank operations, and especially their asset quality, banks have to adhere to various limitations. 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. As the former acts, the new Banking Act prescribes that banks are obliged to observe the limitations on exposure and the extent of investments, and regularly report to the Croatian National Bank on the amount and type of their exposure and the extent of their investments. The following limitations are prescribed:

- ❑ A bank's exposure to a single person may not exceed 25% of its regulatory capital (does not apply to a bank's exposure to the entities which constitute a banking group and are subject to consolidation).
- ❑ A bank's overall exposure to the persons directly or indirectly controlled by the bank or to the persons directly or indirectly controlled by the person controlling the bank may not exceed 20% of its regulatory capital (does not apply to a bank's exposure to the entities which constitute a banking group and are subject to consolidation).
- ❑ A bank's exposure to a single person in a special relationship with a bank may not exceed 10% of its regulatory capital. Persons in a special relationship with a bank are: a) the shareholders of the bank owning 5% or more of voting shares at the general meeting of the bank and their close relatives, b) the members of the bank management and supervisory board, the bank's procurators and their close relatives, c) persons who have concluded work contracts with the bank under special terms, d) legal persons in whose capital the persons referred to above own more than 20% of voting shares, e) legal persons in whose capital the bank owns more than 20% of voting shares or controls these legal persons in a different way.

- ❑ The sum of all large exposures may not exceed 600% of the bank's regulatory capital. Large exposure of a bank is exposure to one person equaling or exceeding 10% of its regulatory capital.
- ❑ Total investments of a bank in land, buildings, equipment and the furnishing of business premises may not exceed 40% of its regulatory capital.
- ❑ Total bank's investments in the capital of non-financial institutions may not exceed 30% of its regulatory capital.
- ❑ A bank's investment in the capital of a single non-financial institution may not exceed 15% of its regulatory capital.

## 3.5 Bank Earnings Quality

In 2002, the banks reported a profit of HRK 2,330.4m. 42 of the 46 banks earned profit amounting to HRK 2,404.6m, whereas 4 banks incurred losses amounting to a total of HRK 74.2m.

Table 3.9 Bank Income Statement  
in million HRK and %

	2000	2001		2002	
	Amount	Amount	Change	Amount	Change
1. Net interest income	4,325.1	4,658.1	7.7	5,288.5	13.5
1.1. Interest income	8,398.0	8,973.6	6.9	9,939.8	10.8
1.2. Interest expenses	4,073.0	4,315.5	6.0	4,651.3	7.8
2. Net non-interest income	1,980.6	1,256.7	-36.6	2,276.1	81.1
2.1. Non-interest income	2,878.8	3,230.8	12.2	4,166.9	29.0
2.2. Non-interest expenses	898.1	1,974.1	119.8	1,890.8	-4.2
3. General administrative expenses and depreciation	3,577.7	3,878.1	8.4	4,536.9	17.0
4. Net operating income before provisions	2,728.0	2,036.7	-25.3	3,027.7	48.7
5. Loan loss provision expenses	1,298.6	807.9	-37.8	438.0	-45.8
6. Pre-tax profit/loss	1,429.4	1,228.8	-14.0	2,589.8	110.8
7. Income tax	123.3	334.6	171.4	259.4	-22.5
8. After-tax profit/loss	1,306.1	894.2	-31.5	2,330.4	160.6

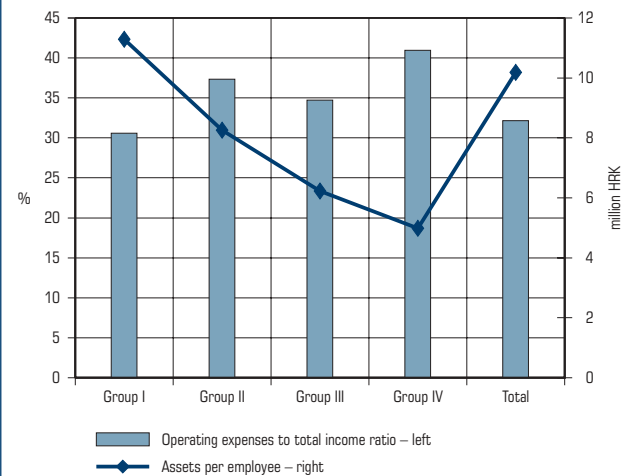
As shown in Table 3.9, net interest income increased by 13.5% as compared to 2001 due to interest income growth larger than interest expenses growth. Net non-interest income rose by a high 81.1% compared to the previous year due to a strong growth in fee income from payment transaction services, whereas non-interest expenses declined by 4.2%. It should be noted that non-interest expenses were extremely high in 2001 due to established losses of Riječka banka d.d., Rijeka, which had been incurred in the previous periods. Hence, non-interest expenses in 2001 are not comparable with that

Figure 3.6

## Return on Average Assets and Return on Average Equity



Figure 3.7

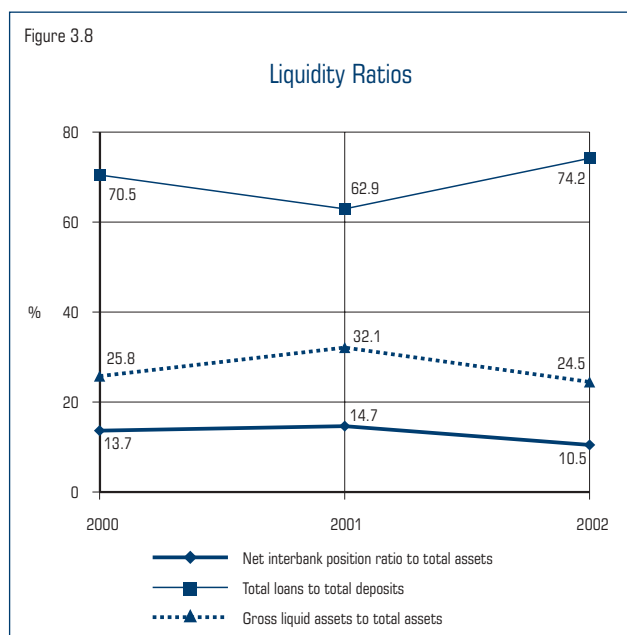
Operating Efficiency in 2002  
by Peer Groups of Banks

of 2002. Net interest income against average interest bearing assets fell from 4.0% in 2001 to 3.6% in 2002 owing to a fast asset growth. Although general administrative expenses and depreciation grew strongly in 2002 (17%) compared to 2001, the described favorable movements in income statement items led to a substantial increase in net operating income before provisions (48.7%).

Loan loss provision expenses declined by 45.8%, which leads to the conclusion that asset quality improved in 2002. Earned profit grew by 160.6% over that in the previous year, which triggered the upward trend in the return on average assets (ROAA) and return on average equity (ROAE) indicators, which both declined in 2001 (Figure 3.6). Large banks in Group I managed their resources better than the banks in other three groups, which had an impact on the efficiency of the entire banking system (Figure 3.7).

## 3.6 Bank Liquidity

Figure 3.8 shows some liquidity ratios trends at the level of all commercial banks. The net interbank position ratio<sup>7</sup> fell from 14.6% in 2001 to 10.5% in 2002. The total loans to total deposits ratio grew considerably (from 62.9% at end-2001 to 74.2% at end-2002), while the gross liquid assets to total assets ratio declined, after growing in 2001. The data on subscriptions for CNB bills show that subscribed kuna and foreign currency CNB bills stood at HRK 5,805.9m and HRK 1,226.9m respectively at the end of 2002, whereas they stood at HRK 6,214.9m and HRK 2,808.4m at the end of 2001. Such developments in liquidity ratios were caused by the described increase in loans, which led to the decline in liquid assets. However, the liquidity of banks remained high, and CNB loans were not utilized by any of the banks at the end of 2002.



## 3.7 Savings Banks and Housing Savings Banks Performance

Savings banks and housing savings banks accounted for only 1.3% of the total assets of the banking sector. At end-2002, there were 3 housing savings banks and 1 savings bank in operation (see Table 3.1). The number of savings banks decreased, which led to a 0.6% decline in total savings banks and housing savings bank assets, despite a 68.3% asset growth of housing savings banks in 2002.

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

At the end of 2002, savings banks and housing savings balance sheet reflected the structure of housing savings banks balance sheet, while the share of one savings bank was almost negligible. Table 3.10 shows that securities (Ministry of Finance treasury bills and CNB bills) and the trading portfolio of securities increased in 2002, both in nominal

<sup>7</sup> The difference between assets placed with financial institutions and assets received from financial institutions, relative to total assets.

terms and in terms of their share in total savings bank and housing savings bank assets. Owing to a decline in the number of savings banks, almost all other items recorded a significant decline, both in nominal terms and in terms of their share in the asset structure.

**Table 3.10 Structure of Savings Bank and Housing Savings Bank Assets**  
end of period, in million HRK and %

	2000			2001			2002		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Money assets and deposits with the CNB	91.6	5.8	2.1	156.8	6.6	71.1	27.9	1.2	-82.2
1.1 Money assets	34.5	2.2	42.1	54.7	2.3	58.5	4.7	0.2	-91.4
1.2 Deposits	57.1	3.6	-12.8	102.0	4.3	78.7	23.2	1.0	-77.3
2. Deposits with banking institutions	99.0	6.3	6.3	123.5	5.2	24.8	61.6	2.6	-50.1
3. MoF treasury bills and CNB bills	237.3	15.0	87.7	418.9	17.6	76.5	561.5	23.7	34.0
4. Trading portfolio of securities	144.4	9.2	4,605.6	472.6	19.8	227.4	1,149.6	48.5	143.2
5. Loans to financial institutions	10.8	0.7	-78.7	14.4	0.6	34.4	13.7	0.6	-5.0
6. Loans to other clients	625.7	39.7	-5.5	701.2	29.4	12.1	200.2	8.4	-71.4
7. Investment portfolio of securities	190.9	12.1	488.4	337.0	14.1	76.5	277.8	11.7	-17.6
8. Investments in subsidiaries and associates	1.4	0.1	2.6	1.1	0.0	-18.1	1.2	0.1	5.9
9. Foreclosed and repossessed assets	17.7	1.1	-31.3	16.4	0.7	-7.5	6.0	0.3	-63.1
10. Tangible assets and software (net of depreciation)	57.2	3.6	-14.0	56.2	2.4	-1.6	25.9	1.1	-54.0
11. Interest, fees and other assets	109.6	6.9	-23.1	96.1	4.0	-12.4	48.4	2.0	-49.6
12. Net of: Specific reserves for unidentified losses	7.9	0.5	4.6	9.0	0.4	13.8	2.6	0.1	-70.6
Total	1,577.6	100.0	22.7	2,385.3	100.0	51.2	2,371.2	100.0	-0.6

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

	2000			2001			2002		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Loans from financial institutions	13.6	0.9	-52.8	3.5	0.1	-74.1	0.0	0.0	-100.0
1.1. Short-term loans	12.4	0.8	-50.1	2.5	0.1	-79.8	0.0	0.0	-100.0
1.2. Long-term loans	1.2	0.1	-69.9	1.0	0.0	-15.9	0.0	0.0	-100.0
2. Deposits	1,197.0	75.9	44.9	1,964.8	82.4	64.1	2,175.3	91.7	10.7
2.1. Giro account and current account deposits	7.0	0.4	5.5	6.7	0.3	-3.5	0.3	0.0	-95.3
2.2. Savings deposits	46.9	3.0	21.4	47.2	2.0	0.7	7.6	0.3	-83.9
2.3. Time deposits	1,143.2	72.5	46.4	1,910.9	80.1	67.2	2,167.4	91.4	13.4
3. Other loans	4.4	0.3	-48.0	2.0	0.1	-54.0	0.0	0.0	-100.0
3.1. Short-term loans	3.8	0.2	-51.2	2.0	0.1	-47.2	0.0	0.0	-100.0
3.2. Long-term loans	0.6	0.0	-5.5	0.0	0.0	-100.0	0.0	0.0	-
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	52.5	3.3	1.1	28.0	1.2	-46.7	0.0	0.0	-99.9
5.1. Subordinated instruments issued	7.9	0.5	-38.4	3.8	0.2	-51.4	0.0	0.0	-100.0
5.2. Hybrid instruments issued	44.7	2.8	14.0	24.2	1.0	-45.9	0.0	0.0	-99.9
6. Interest, fees and other liabilities	64.5	4.1	21.7	85.1	3.6	31.9	45.2	1.9	-46.9
7. Profit/loss for the current year	-66.1	-4.2	59.6	-29.4	-1.2	-55.5	27.3	1.1	-192.6
8. Capital	311.6	19.8	-13.2	331.2	13.9	6.3	123.4	5.2	-62.7
Total	1,577.6	100.0	22.7	2,385.3	100.0	51.2	2,371.2	100.0	-0.6

Deposits were dominant in the liability structure of savings banks and housing savings banks, amounting to HRK 2,175.3m at the end of 2002. Their share in total liabilities had an upward trend (from 82.4% at end-2001 to 92.7% at end-2002) and, despite the decrease in the number of savings banks, they grew by 10.7% in nominal terms thanks to the deposit growth recorded in housing savings banks. The share of all other liability items in total liabilities was negligible.

### 3.7.2 Savings Bank and Housing Savings Bank Capital

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

	2000		2001			2002		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
1. Share capital	339.5	109.0	379.4	114.5	11.7	183.4	148.6	-51.7
2. Retained income/loss	-52.9	-17.0	-64.7	-19.5	22.4	-73.2	-59.3	13.1
3. Legal reserves	4.0	1.3	3.6	1.1	-7.9	0.3	0.3	-90.8
4. Reserves provided for by the articles of association and other capital reserves	21.0	6.7	12.9	3.9	-38.4	12.9	10.4	-0.4
Total	311.6	100.0	331.2	100.0	22.9	123.4	100.0	-62.7

Savings bank and housing savings bank capital declined in 2002 in comparison with 2001, both in nominal terms and in terms of its share in total assets. Still, housing savings bank capital rose by 20.1%. The structure of savings bank and housing savings bank capital is shown in Table 3.12.

At the end of 2002, the regulatory capital of savings banks and housing savings banks amounted to HRK 120.4m, down from HRK 294.8m as at 31 December 2001. The capital adequacy ratio of savings banks and housing savings banks stood at 31.9% at the end of 2002, compared to 37.3% at the end of 2001. 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 2002, fully recoverable placements (groups A and B) accounted for 98.0% of total risk assets of savings banks and housing savings banks. Partly recoverable placements (groups C and D) accounted for 1.7% of total risk assets, while irrecoverable placements (group E) accounted for 0.3% of total risk assets. Total impairment (placement reduction by the amount of established losses arising from partly recoverable and irrecoverable placements together with reserves for unidentified losses) amounted to

Table 3.13 Classification of Savings Bank and Housing Savings Bank Placements by Risk Groups  
end of period, in million HRK and %

Placements	2000		2001		2002	
	Amount	Share	Amount	Share	Amount	Share
1. Fully recoverable placements	1,239.1	90.5	1,653.8	93.4	1,052.3	98.0
1.1. Group A	1,177.7	86.0	1,582.9	89.4	986.3	91.9
1.2. Group B	61.4	4.5	70.9	4.0	66.0	6.1
2. Partly recoverable placements	86.8	6.3	79.5	4.5	18.1	1.7
2.1. Group C	50.7	3.7	59.8	3.4	14.1	1.3
2.2. Group D	36.1	2.6	19.7	1.1	4.0	0.4
3. Irrecoverable placements	43.8	3.2	36.6	2.1	3.2	0.3
3.1. Group E	43.8	3.2	36.6	2.1	3.2	0.3
Total	1,369.6	100.0	1,770.0	100.0	1,073.6	100.0

Table 3.14 Total Provision to Total Placement Ratio of Savings Banks and Housing Savings Banks  
end of period, in million HRK

	2000	2001	2002
1. Total provisions for losses	94.9	82.5	18.6
1.1. Placement value impairment (loss)	87.2	73.5	16.0
1.2. Provisions for unidentified losses	7.7	9.0	2.6
2. Total placements	1,369.6	1,770.0	1,073.6
3. Relative ratio of total provisions to total placements	6.9	4.7	1.7

HRK 18.6m or 1.7% of total placements at the end of 2002. It had a downward trend in the reporting period, both in nominal terms and in terms of their share in total placements.

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

Table 3.15 Savings Bank and Housing Savings Bank Income Statement  
in million HRK and %

	2000	2001		2002	
	Amount	Amount	Change	Amount	Change
1. Net interest income	76.0	90.9	19.6	44.5	-51.0
1.1. Interest income	193.8	208.6	7.6	114.4	-45.2
1.2. Interest expenses	117.8	117.7	-0.1	69.9	-40.6
2. Net non-interest income	9.9	46.8	373.2	70.3	50.4
2.1. Non-interest income	72.1	101.3	40.5	117.2	15.7
2.2. Non-interest expenses	62.2	54.5	-12.4	46.9	-14.0
3. General administrative expenses and depreciation	131.1	146.2	11.5	80.9	-44.7
4. Net operating income before provisions	-45.3	-8.5	-81.2	34.0	-499.3
5. Loan loss provision expenses	16.2	11.4	-29.6	6.7	-41.1
6. Pre-tax profit/loss	-61.4	-19.9	-67.6	27.3	-237.1
7. Income tax	4.6	3.8	-17.9	0.0	-100.0
8. After-tax profit/loss	-66.0	-23.7	-64.1	27.3	-215.2

In 2002, savings banks and housing savings banks reported a profit of HRK 27.3m. Profit totaling HRK 33.9m was reported by housing savings banks, and the one remaining savings bank reported a loss of HRK 6.6m.

All income statement items (except non-interest income and net non-interest income) declined in nominal terms in 2002 compared with 2001 owing to the decrease in the number of savings banks. The strong growth in net non-interest income of housing savings banks influenced earned profit. Housing savings banks have been operating for only five years and still do not generate high income from interest on loans. Hence, in contrast to banks, their net non-interest income exceeded their net interest income in 2002.