

Annual report
2003



CROATIAN NATIONAL BANK

**Banking System
of the Republic
of Croatia**

3

3.1 Characteristics of the Banking System

At the end of 2003, the banking system of the Republic of Croatia comprised 45 banking institutions: 41 commercial bank and 4 housing savings banks, which is 5 less than at the end of 2002.

Table 3.1 shows the changes in the number of banking institutions in 2003. During the course of the year four banks merged with other banks, while one bank initiated liquidation proceedings.¹ As a result, the number of banks in Croatia declined from 46 at end-2002 to 41 bank at end-2003, while the number of savings banks and housing savings banks remained the same. Although the only remaining savings bank² was forced to initiate liquidation proceedings, 2003 saw the establishment of a new housing savings bank.³

Table 3.1 Changes in the Number of Banking Institutions

Banks	2001	2002	2003
Number of banks at the beginning of the year	43	43	46
Former savings banks that were granted bank license	1	7	–
Banks that merged with other banks	–	–3	–4
Banks undergoing bankruptcy proceedings	–	–	–1
Banks whose license was revoked	–1	–	–
Foreign bank branch removed from the register	–	–1	–
Number of banks at the end of the year	43	46	41
Savings banks and housing savings banks	2001	2002	2003
Number of savings banks at the beginning of the year	26	19	4
Savings banks that were granted bank license	–	–	1
Savings banks transformed into banks	–1	–7	–
Savings banks that merged with other banks/savings banks	–2	–4	–
Savings banks undergoing liquidation	–2	–3	–1
Savings banks undergoing bankruptcy proceedings	–	–1	–
Savings banks whose license was revoked	–2	–	–
Number of savings banks and housing savings banks at the end of the year	19	4	4
– housing savings banks	4	3	4

Source: CNB.

In the reporting three-year period, the share of banks in majority foreign ownership in total bank assets continually rose, while the share of banks in majority domestic ownership reduced (Table 3.2). The number of banks in total or majority private ownership of domestic shareholders as well as the number of banks in total or majority foreign ownership decreased in 2003, primarily due to the contin-

1 Cassa di Risparmio di Trieste - Banca d.d., Zagreb merged with Zagrebačka banka d.d., Zagreb, HVB Bank Croatia d.d., Zagreb merged with Splitska banka d.d., Split, Zagorska banka d.d., Krapina merged with Samoborska banka d.d., Samobor, Erste & Steiermärkische Bank d.d., Zagreb merged with Riječka banka d.d., Rijeka, which changed its name to Erste & Steiermärkische Bank d.d., Rijeka, while Convest banka d.d., Zagreb initiated liquidation proceedings.

2 Međimurska štedionica d.d., Čakovec.

3 PBZ stambena štedionica d.d., Zagreb.

Table 3.2 Ownership Structure of Banks

Ownership structure	Number of banks			Share of assets in total bank assets		
	2001	2002	2003	2001	2002	2003
Banks in total or majority private ownership of domestic shareholders	16	21	20	5.6	5.8	5.6
Banks in total or majority state ownership	3	2	2	5.0	4.0	3.4
Banks in total or majority foreign ownership	24	23	19	89.3	90.2	91.0
Total	43	46	41	100.0	100.0	100.0

Source: CNB.

uation of the consolidation process in the banking system and several mergers it witnessed. However, during the period in question the share of bank assets in full or majority foreign ownership in total bank assets increased mildly, from 90.2% to 91%, while the share of bank assets in total or majority private ownership of domestic shareholders decreased slightly, to 9% from 9.8%.

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 bank assets.

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

Assets	Number of banks			Share of assets of peer groups of banks in total bank assets		
	2001	2002	2003	2001	2002	2003
Group I Assets exceeding 5,000	6	9	8	70.7	79.6	82.9
Group II Assets from 1,000 to 5,000	14	12	11	23.1	15.2	12.5
Group III Assets from 500 to 1,000	7	7	8	3.3	2.7	2.7
Group IV Assets below 500	16	18	14	2.9	2.5	1.9
Total	43	46	41	100.0	100.0	100.0

Source: CNB.

The number of banks with assets exceeding HRK 5bn (Group I) reduced from 9 to 8 in 2003, whereas their share in total bank assets went up from 79.7% in 2002 to 82.9% in 2003.⁴ The number of banks with assets ranging from HRK 1bn to 5bn (Group II) declined from 12 to 11 in 2003, with their share in total bank assets falling from 15.2% to 12.5%.⁵ Groups III and IV (totalling 22 banks), which comprise banks with assets from HRK 0.5bn to 1bn, accounted together for only 4.6% of total bank assets at end-2003. Group I encompasses banks with very different asset sizes, with assets of the two largest banks far above those of other Group I banks. By contrast, Group II banks make up a more homogeneous group in terms of asset size. Group III consists of similar small banks and Group IV comprises small banks of different sizes, of which 5 were formerly savings banks.

4 This group includes Zagrebačka banka d.d., Zagreb, Privredna banka Zagreb d.d., Zagreb, Raiffeisenbank Austria d.d., Zagreb, Splitska banka d.d., Split, Hypo Alpe-Adria-Bank d.d., Zagreb, Erste & Steiermärkische Bank d.d., Zagreb, Hrvatska poštanska banka d.d., Zagreb, Nova banka d.d., Zagreb and Riječka banka d.d., Rijeka, which merged with Erste & Steiermärkische Bank d.d., Zagreb, from the same bank group, creating a new bank which operates under the name Erste & Steiermärkische Bank d.d., Rijeka.

5 Karlovačka banka d.d., Karlovac joined this group in 2003, while Dresdner Bank Croatia d.d., Zagreb and HVB Bank Croatia d.d., Zagreb, which merged with Splitska banka d.d., Split exited the group.

These data also show that Group I banks, i.e. the country's largest banks, continued increasing their share in total banking sector assets.

Croatia's banking system is dominated by six banks/banking groups, accounting for 84.1% of total banking sector assets,⁶ with all of them being majority foreign-owned. Competition among banks and banking groups has been rising, as is clearly visible from the continued reduction of interest rates, continued adjustment of loan approval conditions aimed at outperforming the competition and ever increasing number of innovative products on offer specially tailored to fit the needs of different market segments.

As part of its monetary measures, the central bank adopted a Decision on the Compulsory Purchase of CNB Bills⁷ early in 2003, under which banks whose placements' growth and the growth of other specified assets items exceeded the targeted 16% annually were required to subscribe CNB bills in the amount equal to 200% of the exceeded growth. In order to avoid the unattractive yield from having to subscribe CNB bills at 0.5% annual interest rate banks adopted different measures and adjusted their business activity so as not to be obligated to subscribe CNB bills. In the end, the Decision covered only fifteen banks because it had prompted banking groups to make use of their synergy and allocate financial products among their group members in a way which gave them better control over their asset growth. This resulted in the expansion of leasing companies, housing savings banks, asset management companies etc. The side effect of the decision in question were innovations such as trading in loans and loan portfolios among banks as well as development of an evaluation and pricing system for such transactions. The very appearance of said transactions points to the level of solidarity among banks in the market and also to the existence of market characteristics inherent to developed secondary loan markets.

In 2003, the CNB undertook different steps to establish co-operation with supervisory authorities of banks owning Croatian banks as well as banks owned by Croatian banks. As a result, the 2003 saw the signing of the Memorandum of Understanding and Co-operation in Banking Supervision with the agency responsible for bank supervision in Bosnia and Herzegovina, while similar agreements are underway with the responsible authorities in Austria and Italy.

6 Banks/banking groups dominating the national banking system include: Zaba Group (Zagrebačka banka d.d. and Varaždinska banka d.d.), PBZ Group (Privredna banka Zagreb d.d., Riadria banka d.d., Međimurska banka d.d. and Privredna banka – Laguna banka d.d.), HAA Group (Hypo Alpe-Adria-Bank d.d. and Slavonska banka d.d.), Splitska banka d.d., Raiffeisenbank Austria d.d. and Erste & Steiermärkische Bank d.d.

7 Official gazette *Narodne novine*, Nos. 10/2003, 54/2003 and 203/2003.

3.2 Balance Sheet Structure of Banks

3.2.1 Bank Asset Structure

Total bank assets amounted to HRK 204.5bn⁸ at the end of 2003, which is a 17.4% increase on the end of 2002 when they stood at HRK 174.1bn (Table 3.4). This was mostly the result of the rise in net loans to other clients (non-financial sector), which stood at HRK 107.2bn at the end of 2003 and grew by 17.1bn or 18.9% compared to the end of 2002. To finance this rise banks used funds obtained from deposit growth and received loans. The share of loans to other clients in the structure of bank assets increased from 51.8% at end-2002 to 52.4% at end-2003.

Loan growth exceeding 20% was recorded at 23 banks. The six largest banks,⁹ whose share in total bank assets stood at 77.6% at end-2003, accounted for 85% of the nominal increase in total loans, whereas four leading banks, with a 62.58% share in total bank assets, accounted for 75.4% of nominal loan growth. Six banks recorded a nominal decrease in loans compared to the previous year.

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

	2001			2002			2003		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Money assets and deposits with the CNB	22,196.3	15.0	93.2	21,387.9	12.3	-3.6	27,993.6	13.7	30.9
1.1. Money assets	7,822.5	5.3	419.3	2,236.9	1.3	-71.4	2,955.7	1.4	32.1
1.2. Deposits	14,373.9	9.7	44.0	19,151.0	11.0	33.2	25,037.9	12.2	30.7
2. Deposits with banking institutions	23,900.1	16.1	35.1	20,146.2	11.6	-15.7	31,186.6	15.2	54.8
3. MoF treasury bills and CNB bills	9,687.2	6.5	59.9	10,116.7	5.8	4.4	7,829.7	3.8	-22.6
4. Trading portfolio of securities	4,795.6	3.2	94.8	8,408.9	4.8	75.3	7,354.5	3.6	-12.5
5. Loans to financial institutions	1,479.6	1.0	36.3	2,157.8	1.2	45.8	3,057.0	1.5	41.7
6. Loans to other clients	64,402.5	43.4	28.5	90,135.1	51.8	40.0	107,165.6	52.4	18.9
7. Investment portfolio of securities	12,741.3	8.6	-10.1	12,684.7	7.3	-0.4	10,961.9	5.4	-13.6
8. Investments in subsidiaries and associates	2,199.8	1.5	-8.8	2,448.2	1.4	11.3	2,448.0	1.2	0.0
9. Foreclosed and repossessed assets	446.8	0.3	-27.3	375.4	0.2	-16.0	354.1	0.2	-5.7
10. Tangible assets and software (net of depreciation)	3,501.2	2.4	7.6	3,755.4	2.2	7.3	4,092.5	2.0	9.0
11. Interest, fees and other assets	4,273.5	2.9	34.8	4,042.3	2.3	-5.4	3,805.6	1.9	-5.9
12. Net of: Specific reserves for unidentified losses	1,195.7	0.8	71.0	1,519.4	0.9	27.1	1,745.2	0.9	14.9
Total	148,428.3	100.0	32.7	174,139.2	100.0	17.3	204,503.9	100.0	17.4

Source: CNB.

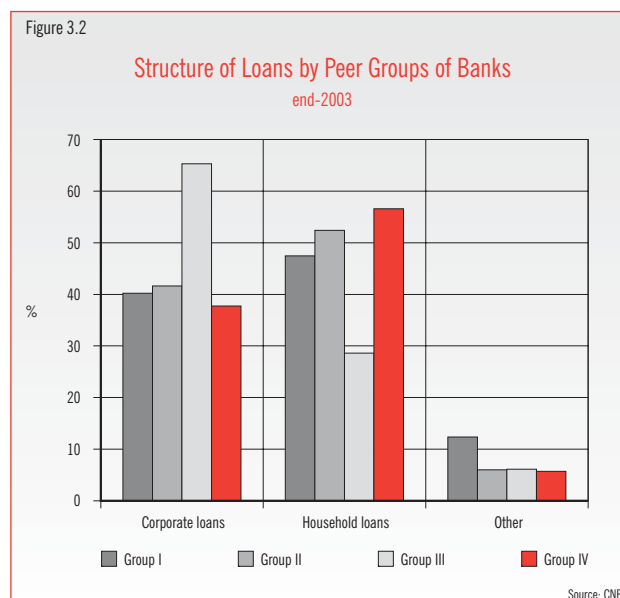
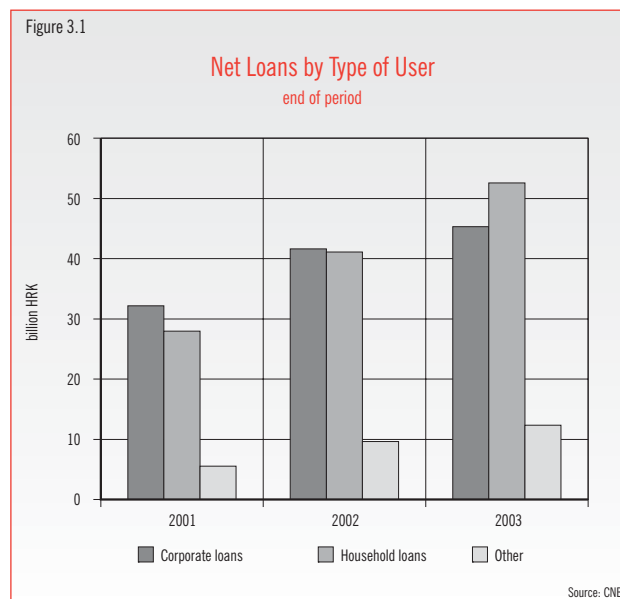
⁸ All financial data are based on preliminary unaudited bank reports for 2003.

⁹ Zagrebačka banka d.d., Privredna banka Zagreb d.d., Erste & Steiermärkische Bank d.d., Splitska banka d.d., Raiffeisenbank Austria d.d. and Hypo Alpe-Adria-Bank d.d.

Figure 3.1, which shows net loans by type of user, indicates that strong credit activity related to households, which started over the previous years, continued into 2003. Net household loans totalled HRK 52.6bn in 2003, while in 2002 they amounted to HRK 41.1bn. Large banks led the way, as evident from Figure 3.2 which shows the structure of total net loans by 4 peer groups of banks classified by asset size. Household loans predominated in Group I (47.4%), Group II (52.4%) and Group IV (56.6%). Although household loans predominated in Group I, two banks from this group, one being in majority state ownership, granted predominantly corporate loans. Corporate loans predominated also in Group III, in which they accounted for 65.3% of total granted loans. The influence of this group, with its 2.7% share in total bank assets, on the entire banking system was negligible, while movements in the loan structure of other groups resulted in a larger share of household loans, totalling 47.7%, than the share of corporate loans, amounting to 41.1%. The share of other loans (loans to financial institutions, the public sector, non-profit institutions and non-residents) accounted for 12.4% of total loans granted by Group I banks. The shares of other loans in total loans granted by remaining three bank groups ranged from 5.7% to 6.1% at end-2003.

Table 3.4 shows that cash at banks increased substantially, while deposits with the CNB continued the previously started trend of strong growth (compared to 2002 they grew 30.7%, while their share went up from 11% to 12.2%). This was influenced by the Decision on the Compulsory Purchase of CNB bills and the increase in kuna reserve requirements allocated with the CNB.

Deposits with banking institutions registered substantial growth, both in absolute terms, increasing by as much as 54.8%, and in relative terms (an increase of their share in assets), primarily due to the Decision on the Minimum Required Amount of Foreign Currency Claims.¹⁰ Investments in MoF T-bills and CNB bills reduced substantially compared to previous periods, primarily due to low yields registered in 2003. The trading portfolio of securities reduced by 12.5% on 2002, with its share in the total asset structure totalling 3.6% compared to 4.8% registered in the previous year. The said reduction in investments in the trading portfolio of securities spilled over to loans to other clients, that is, deposits with the CNB. The largest por-



¹⁰ Pursuant to the Decision on the Minimum Required Amount of Foreign Currency Claims banks are obligated to maintain a minimum of 35% of their foreign currency liabilities by foreign currency claims.

tion of the trading portfolio of securities at the end of 2003 consisted of bonds issued by the Republic of Croatia, T-bills and CNB bills as well as bonds issued by foreign countries and financial institutions.

3.2.2 Bank Liability Structure

Deposits predominated in the bank liability structure. At end-2003, they accounted for 70.3% of total liabilities, which is less than at end-2002 when they amounted to 71.5% (Table 3.5). Almost all banking groups registered similar deposit shares in total liabilities, while deposits were most prominent in the liabilities of Group II banks with a share of 72.3%, as illustrated by Figure 3.3. In 2003, total deposit growth amounted to HRK 19.3bn, while total credit growth was lower, totalling HRK 17.9bn. At 13 banks the 2003 deposit growth rate was above 20%, with the four leading banks accounting for 84.7% of the total nominal deposit growth. Six banks registered a decline in deposits compared to end-2002. Time deposits increased by HRK 16.5bn or 21.4%, of which deposits of foreign financial institutions grew the most (accounting for 41% of the overall nominal deposit growth) followed by household time deposits and corporate time deposits. Giro and current account deposits also went up (by HRK 2bn or 8.5%), of which household giro and current account deposits, accounting for 7.8% of the total nominal growth, went up the most. Due to the faster growth of corporate deposits

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

	2001			2002			2003		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Loans from financial institutions	3,629.1	2.4	3.4	4,084.6	2.3	12.6	7,111.7	3.5	74.1
1.1. Short-term loans	595.7	0.4	-47.3	1,184.4	0.7	98.8	3,689.1	1.8	211.5
1.2. Long-term loans	3,033.3	2.0	27.4	2,900.2	1.7	-4.4	3,422.6	1.7	18.0
2. Deposits	104,697.2	70.5	44.0	124,471.8	71.5	18.9	143,754.2	70.3	15.5
2.1. Giro account and current account deposits	16,548.6	11.1	31.1	23,272.3	13.4	40.6	25,240.1	12.3	8.5
2.2. Savings deposits	26,373.9	17.8	49.1	23,980.0	13.8	-9.1	24,773.1	12.1	3.3
2.3. Time deposits	61,774.6	41.6	45.8	77,219.6	44.3	25.0	93,741.0	45.8	21.4
3. Other loans	15,947.7	10.7	-2.3	19,492.6	11.2	22.2	25,080.3	12.3	28.7
3.1. Short-term loans	594.0	0.4	18.0	4,451.2	2.6	649.4	3,429.0	1.7	-23.0
3.2. Long-term loans	15,353.7	10.3	-3.0	15,041.4	8.6	-2.0	21,651.3	10.6	43.9
4. Debt securities issued	19.4	0.0	-	24.7	0.0	27.6	169.0	0.1	583.0
4.1. Short-term debt securities issued	0.0	0.0	-	5.2	0.0		0.0	0.0	-100.0
4.2. Long-term debt securities issued	19.4	0.0	-	19.6	0.0	1.0	169.0	0.1	763.0
5. Supplementary capital	2,655.8	1.8	410.4	2,910.2	1.7	9.6	3,075.2	1.5	5.7
5.1. Subordinated instruments issued	339.4	0.2	20.0	641.3	0.4	89.0	813.6	0.4	26.9
5.2. Hybrid instruments issued	2,316.4	1.6	875.7	2,268.9	1.3	-2.1	2,261.6	1.1	-0.3
6. Interest, fees and other liabilities	7,783.0	5.2	42.1	6,646.4	3.8	-14.6	6,834.1	3.3	2.8
7. Profit/loss for the current year	570.0	0.4	-49.3	1,925.5	1.1	237.8	2,738.7	1.3	42.2
8. Capital	13,126.3	8.8	7.6	14,583.3	8.4	11.1	15,740.7	7.7	7.9
Total	148,428.3	100.0	32.7	174,139.2	100.0	17.3	204,503.9	100.0	17.4

Source: CNB.

and deposits of financial institutions, the share of household deposits in total deposits reduced from 58.7% to 55.4%. As in the previous years, the majority of deposits were denominated in foreign currency (67.6%).

Received loans accounted for the second largest share in the liability structure. Other loans received rose by 28.7% compared to the end of 2002, while loans from financial institutions went up 74.1% (Table 3.5). The share of total received loans (loans from financial institutions and other loans) in the liability structure rose from 13.5% at end-2002 to 15.8% at end-2003, while the largest contribution to total received loans came from loans from foreign financial institutions (74.6%), followed by CBRD loans, which made up 9.7% of total received loans. Maturities of 77.9% of total received loans were longer than 1 year.

The liability structure by peer groups of banks (Figure 3.3) shows that Group I banks (21.7%) and Group II banks (17.3%) used other sources the most. 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 (8.3%), while it accounted for as much as 19.4% at Group IV banks. Small banks, which comprise Group IV, registered the largest share of share capital in their liability structure.

Household deposits dominated the deposit base of banks, being, relatively speaking, most prominent in total savings deposits and time deposits. Looking at nominal amounts of deposits by type and sector, the importance of household deposits in total deposits may primarily be seen in total time deposits, where their share is 3.8 times larger than their share in total savings deposits.

3.3 Bank Capital

At the end of 2003, bank capital totalled HRK15.7bn, rising 7.9% compared to 2002 (Table 3.6). This was mostly the result of the growth of all items apart from share capital, which during the observed period grew at the rate of only 1.8% or by HRK 173.1m in nominal terms. As a result, share capital continued with its downward trend in the total capital, ending 2003 with a share of 63.5%. Retained income grew at the largest rate of 46.8%, i.e. by HRK 402.5m in nominal terms.

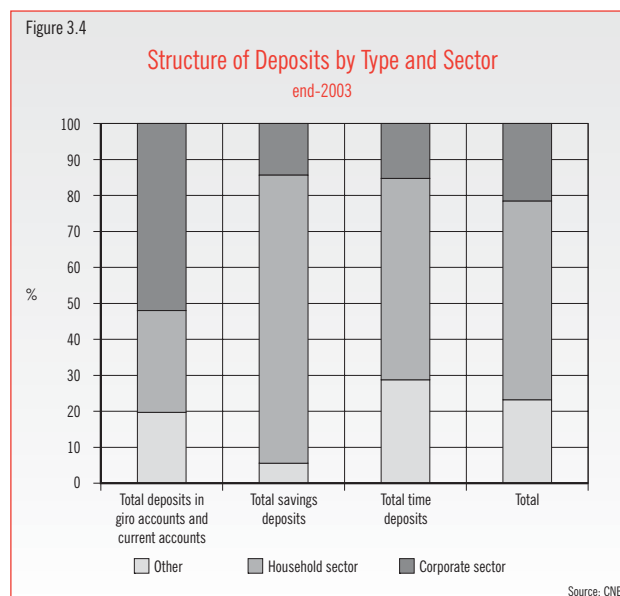
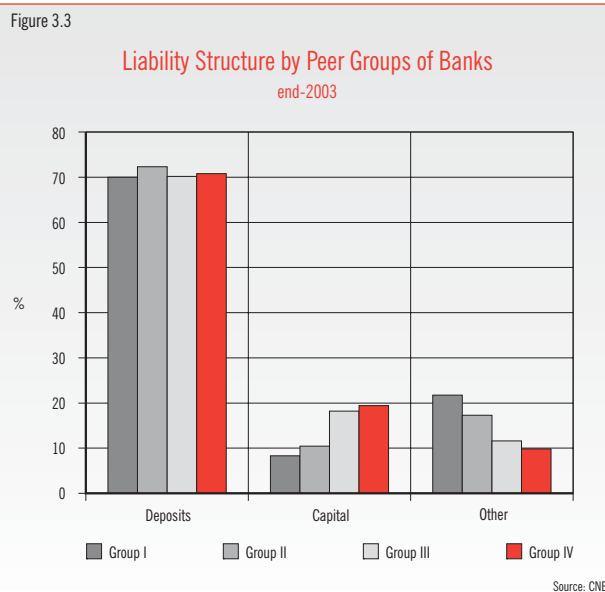


Table 3.6 Structure of Bank Capital
end of period, in million HRK and %

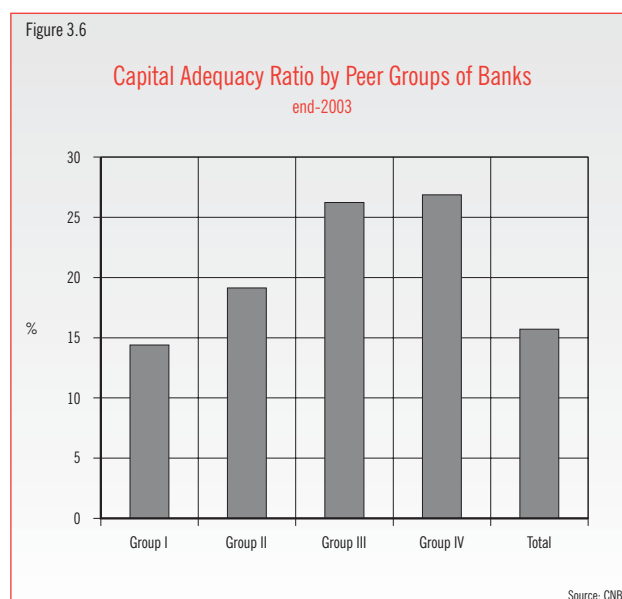
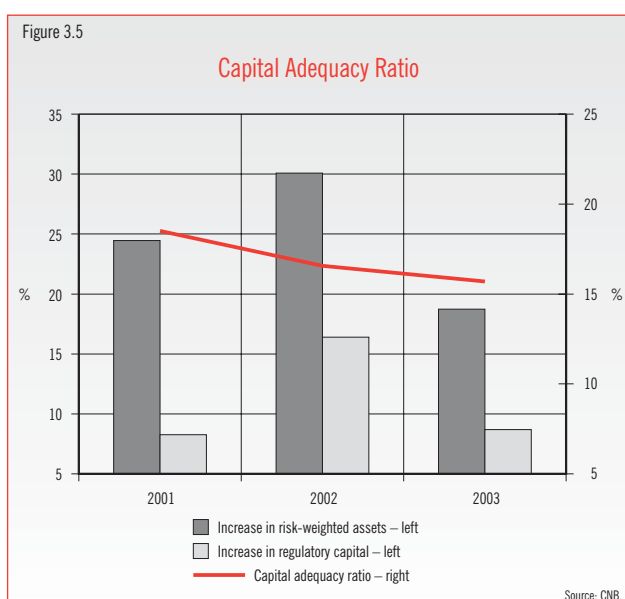
	2001			2002			2003		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Share capital	8,966.5	68.3	4.9	9,772.1	67.0	9.0	9,945.2	63.2	1.8
2. Retained income/loss	77.8	0.6	-76.2	860.3	5.9	1,006.0	1,352.9	8.6	57.3
3. Legal reserves	853.3	6.5	-59.3	583.5	4.0	-31.6	712.0	4.5	22.0
4. Reserves provided for by the articles of association and other capital reserves	3,228.7	24.6	164.5	3,367.4	23.1	4.3	3,820.7	24.3	13.5
5. Profit/loss from the previous year	-	-	-	-	-	-	-90.1	-0.6	-
Total	13,126.3	100.0	2.8	14,583.3	100.0	11.1	15,740.7	100.0	7.9

Source: CNB.

The rise in legal reserves and reserves provided for by the articles of association and other capital reserves totalled 22% and 13.5% respectively.

Regulatory capital is a calculation category to measure a bank's ability to cover unexpected losses. At end-2003, banks' regulatory capital amounted to HRK 18.3bn, which is an 8.9% increase over that at end-2002 when it stood at HRK 16.8bn. Supplementary capital (the share which is included in the regulatory capital) grew at the fastest rate of 18.9%, thus increasing its share in gross regulatory capital to 19.9%. Its growth was prompted primarily by strong growth of subordinated instruments (31%) and an increase in special reserves for unidentified losses (11.8%) which are included in the calculation of regulatory capital. The share of core capital in the regulatory capital structure reduced by 2.1%.

Banks' capital adequacy ratio (regulatory capital to risk-weighted assets ratio) totalled 15.7% at end-2003, which is less than at end-2002 when it stood at 16.6%. All but one bank 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 regulatory capital (Figure 3.5).



Large banks in Group I, whose assets make up 82.9% in total bank assets, had the strongest influence on the capital adequacy at banking system level. Capital adequacy ratio of Group I banks has been on the decline, ending 2003 at 14.4%, while other groups registered a higher capital adequacy ratio (Figure 3.6). This reducing trend in capital available for covering credit risks has been observed for some time.

3.4 Bank Asset Quality

The quality of bank assets in financial reports is assessed in accordance with the International Accounting Standard 39. As regards to the asset share related to their placements, banks are required to adopt and implement their internal placement classification systems, as prescribed by the decisions enacted under the former Banking Act.¹¹

Bank placements (including risky off-balance sheet items) are first classified into three main categories and then into risk groups, depending on the degree of risk. 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 and 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 by which the asset items are reduced. Although placements graded A and B are not subject to individual impairment, banks are required to form reserves for them for unidentified losses. For placements graded A, banks are required to form (set aside) reserves in line with the Decision on the Amount and Method of Forming Specific Reserves to Ensure Against Potential Losses of Banks. For placements classified into group B, banks are required to form reserves in accordance with their own policy.

¹¹ 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.

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

Placements	2001		2002		2003	
	Amount	Share	Amount	Share	Amount	Share
1. Fully recoverable placements	140,586.6	92.7	172,251.3	94.1	200,554.6	94.9
1.1. Group A	137,195.6	90.5	168,693.2	92.2	194,180.4	91.9
1.2. Group B	3,391.0	2.2	3,558.0	1.9	6,374.2	3.0
2. Partly recoverable placements	6,719.5	4.4	6,473.3	3.5	7,414.9	3.5
2.1. Group C	3,193.3	2.1	3,717.8	2.0	4,756.5	2.3
2.2. Group D	3,526.2	2.3	2,755.5	1.5	2,658.4	1.3
3. Irrecoverable placements	4,287.3	2.8	4,245.4	2.3	3,370.2	1.6
3.1. Group E	4,287.3	2.8	4,245.4	2.3	3,370.2	1.6
Total	151,593.3	100.0	182,970.0	100.0	211,339.7	100.0

Source: CNB.

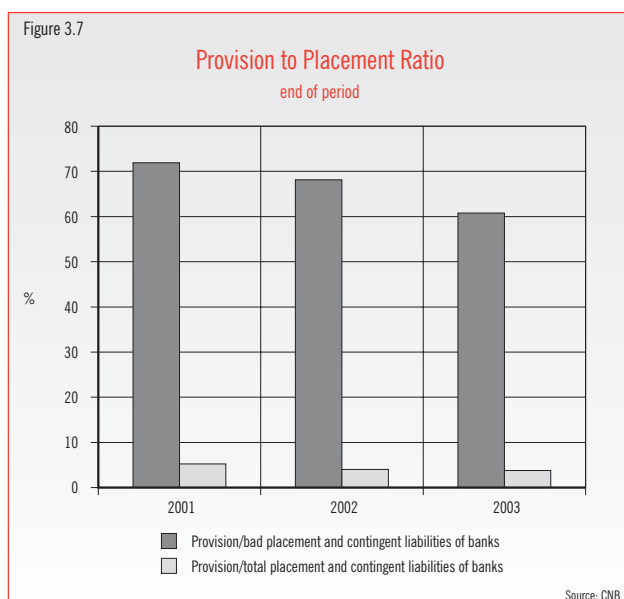
Table 3.8 Total Provision to Total Placement Ratio of Banks
end of period, in million HRK and %

	2001	2002	2003
1. Total provisions for losses	9,326.7	9,121.2	8,590.0
1.1. Placement value impairment (loss)	7,912.1	7,303.4	6,557.4
1.2. Provisions for unidentified losses	1,414.6	1,817.9	2,032.7
2. Total placements	151,593.3	182,970.0	211,339.9
3. Relative ratio of total provisions to total placements	6.2	5.0	4.1

Source: CNB.

At the end of 2003, fully recoverable placements (groups A and B) grew by 1.4% compared to 2002 and accounted for 94.9% of total risk assets (Table 3.7). Partly recoverable placements (groups C and D) went up in nominal terms and accounted for 3.5% of total risk assets, while placements whose present value equals zero (group E) went down in nominal terms and accounted for 1.6% of total risk assets. As shown in Table 3.8, total provisions (placements reduced by the

amount of established losses arising from partly recoverable and irrecoverable placements together with reserves for unidentified losses) totalled HRK 8.6bn at end-2003, 5.8% less than at end-2002. The share of total provisions in total placements continued its downward trend by reducing from 6.2% in 2001 and 5% in 2002 to 4.1% in 2003 (Table 3.8). This downward trend in total provisions, both in absolute amount and relative to total placements, resulted from a 1% increase in the share of group B, but also a lower average provisioning percentage for groups C and D, as well as a reduction in placements of group E. Reserves for unidentified losses rose both in nominal terms and by their share in total reserves, primarily as a result of the method by which the degree of risk is assessed, pursuant to which group B placements are considered fully recoverable and make up the integral part of the base for calculation of reserves for unidentified losses.



Household loans continued growing in 2003, with their share rising from 44.5% in 2002 to 47.7% in 2003. In the household indebtedness structure housing loans accounted for 31.4%. On concern that rapid credit growth might have an adverse effect on bank profitability in the future (due to the possible increase in provisioning expenses), early in 2003 the CNB adopted the Decision on the Compulsory Purchase of CNB Bills aimed at reducing the speedy growth of banks' placements and consequently the need for borrowing abroad. After leading to a successful reduction in placement growth from 30% in 2002 to 14.6% in 2003, the Decision was revoked at the end of 2003. 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 the 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 2004.

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. The applicable Banking Act prescribes that banks are obliged to observe the limitations on exposure and the extent of investments, and regularly report to the CNB 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 in the Republic of Croatia and are subject to CNB's supervision at consolidated level).
- ❑ A bank's overall exposure to 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 in the Republic of Croatia and are subject to CNB's supervision at consolidated level).
- ❑ A bank's exposure to a single person in a special relationship with the bank may not exceed 10% of its regulatory capital. Persons in a special relationship with the bank are: a) shareholders of the bank owning 5% or more of voting shares at the general meeting of the bank and their immediate family members, b) members of the bank management and supervisory board, the bank's procurators and their immediate family members, c) persons who have concluded work contracts with the bank under special terms and their immediate family members, d) legal persons in whose capital 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 equalling 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.

Banks comply with prescribed exposure limitations and investment volumes for commercial banks. Temporary departures have been recorded in cases of a bank's exposure to one person, which is not to exceed 25%. Such deviations are rare, short-term occurrences and as such are characterised as exceptions without a significant effect on the overall banking system.

3.5 Bank Earnings Quality

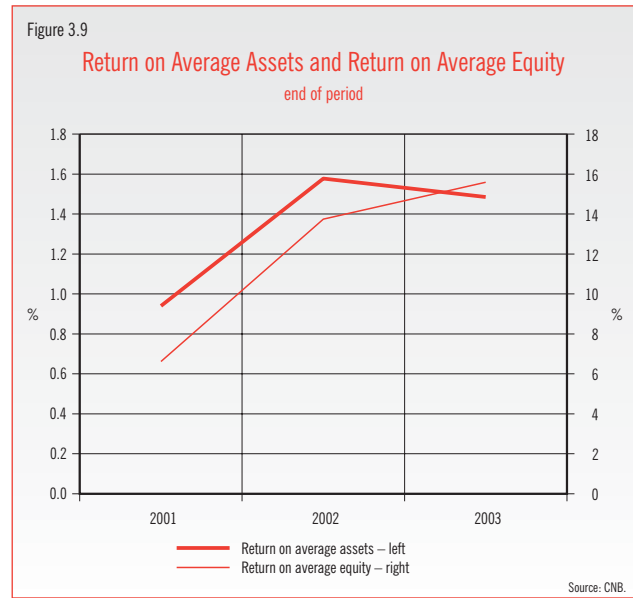
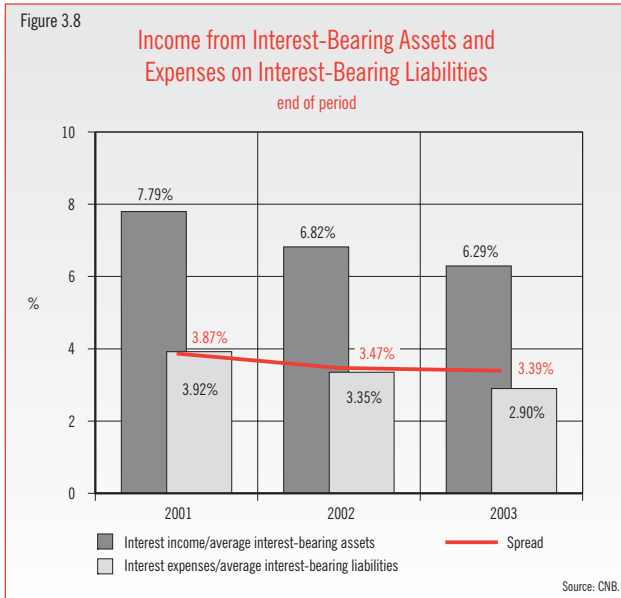
In 2003, banks reported a profit of HRK 2,727.8m. Of 41 banks 36 earned profit amounting to HRK 2,786.1m, while 5 banks incurred losses in the total amount of HRK 58.3m.

Table 3.9 Bank Income Statement
in million HRK and %

	2001		2002		2003	
	Amount	Change	Amount	Change	Amount	Change
1. Net interest income	4,658.1	7.7	5,285.4	13.5	6,330.7	19.8
1.1. Interest income	8,973.6	6.9	9,940.4	10.8	11,119.1	11.9
1.2. Interest expenses	4,315.5	6.0	4,655.0	7.9	4,788.4	2.9
2. Net non-interest income	1,256.7	-36.6	2,175.3	73.1	1,911.8	-12.1
2.1. Non-interest income	3,230.8	12.2	4,107.2	27.1	4,440.6	8.1
2.2. Non-interest expenses	1,974.1	119.8	1,931.9	-2.1	2,528.8	30.9
3. General administrative expenses and depreciation	3,878.1	8.4	4,427.2	14.2	4,832.7	9.2
4. Net operating income before provisions	2,036.7	-25.3	3,033.6	48.9	3,409.9	12.4
5. Loan loss provision expenses	807.9	-37.8	488.8	-39.5	597.8	22.3
6. Pre-tax profit/loss	1,228.8	-14.0	2,544.8	107.1	2,812.1	10.5
7. Income tax	334.6	171.4	470.0	40.5	84.3	-82.1
8. After-tax profit/loss	894.2	-31.5	2,074.8	132.0	2,727.8	31.5

Source: CNB.

As shown in Table 3.9, net interest income generated in 2003 went up 19.8% compared to 2002, resulting from the larger growth of interest income over interest expenses. Net non-interest income reduced 12.1% compared to the previous

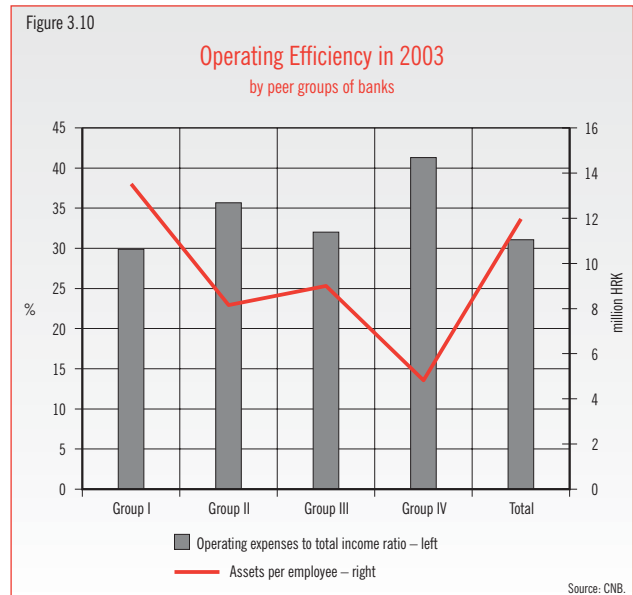


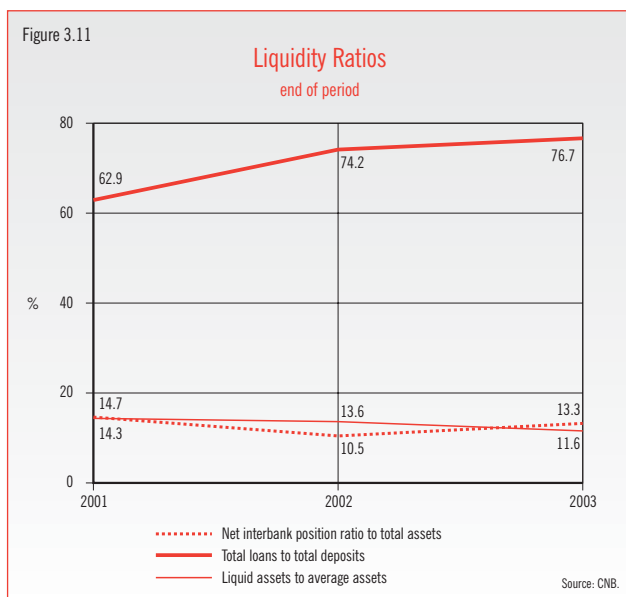
year due to a substantial, 30.9%, growth of non-interest expenses. Net non-interest income rose by only 8.1%. Regardless of the above-mentioned rise in non-interest income and general administrative expenses and depreciation in 2003 (which rose by 9.2%), net operating income before provisions grew by 12.4% on a year earlier.

Interest income measured in relation to average interest-bearing assets declined from 6.82% in 2002 to 6.29% at the end of 2003.

Expenses for loan loss provisions grew by 22.3%, while at the same time the share of bad placements in total placements reduced from 5.9% at the end of 2002 to 5.1% in 2003. Earned profit grew by 31.5% over the previous year, which triggered an upward trend in the return on average assets, while the return on average equity fell, primarily due to a substantial growth of total assets not followed by an increase in profit as it was the case in the previous year when it grew 132% (Figure 3.9). Large banks in Group I managed their resources more successfully than banks in other three groups, which impacted the efficiency of the entire banking system (Figure 3.10).

Respectable results the banking system recorded in 2003 were primarily driven by the volume of business activity in 2003 which will surely be the decisive factor in the future as well.





3.6 Bank Liquidity

Figure 3.11 shows the movements of the three bank liquidity ratios. Net interbank position ratio to total assets¹² grew from 10.5% in 2002 to 13.3% in 2003. The ratio of total loans to total deposits grew mildly from 74.2% at the end of 2002 to 76.7% at the end of 2003, while the gross liquid assets to total assets ratio continued decreasing, from 14.3% in 2001 to 13.6% in 2002, to end 2003 at 11.6%.

3.7 Performance of Housing Savings Bank

At the end of 2003, total assets of housing savings banks amounted to HRK 3,521m. There were 4 housing savings banks, while the only remaining savings bank initiated liquidation proceedings (see Table 3.1). Assets of housing savings banks grew by 48.5% in 2003 compared to the previous year but accounted for only 1.7% of total bank assets.

3.7.1 Balance Sheet Structure of Housing Savings Banks

As shown in Table 3.10 investment portfolio of securities registered the largest growth rate and the largest change in its share in total assets. It grew due to substantially larger investments of housing savings banks in central government bonds. A substantial rise, in nominal terms, was recorded in loans granted to financial institutions (1,441.2%) and investments in MoF T-bills and CNB bills (33.5%). On the other side, there was a serious reduction in deposits with banking institutions (58%), trading portfolio of securities (33.3%), and tangible assets and software (26.6%). Such changes in certain asset items of housing savings banks were driven by changes in the price of capital in the market and changes in the attractiveness of returns on different products.

¹² The difference between assets placed with financial institutions and assets received from financial institutions relative to total assets.

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

	2001			2002			2003		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Money assets and deposits with the CNB	156.8	6.6	71.1	27.9	1.2	-82.2	0.0	0.0	-100.0
1.1. Money assets	54.7	2.3	58.5	4.6	0.2	-91.6	0.0	0.0	-100.0
1.2. Deposits	102.0	4.3	78.7	23.3	1.0	-77.2	0.0	0.0	-100.0
2. Deposits with banking institutions	123.5	5.2	24.8	61.6	2.6	-50.1	25.9	0.7	-58.0
3. MoF treasury bills and CNB bills	418.9	17.6	76.5	561.5	23.7	34.0	749.6	21.3	33.5
4. Trading portfolio of securities	472.6	19.8	227.4	1,149.6	48.5	143.2	766.8	21.8	-33.3
5. Loans to financial institutions	14.4	0.6	34.4	13.7	0.6	-5.0	211.4	6.0	1,441.2
6. Loans to other clients	701.2	29.4	12.1	200.1	8.4	-71.5	187.8	5.3	-6.2
7. Investment portfolio of securities	337.0	14.1	76.5	277.8	11.7	-17.6	1,527.9	43.4	450.1
8. Investments in subsidiaries and associates	1.1	0.0	-18.1	1.2	0.1	5.9	0.0	0.0	-100.0
9. Foreclosed and repossessed assets	16.4	0.7	-7.5	6.0	0.3	-63.1	0.0	0.0	-100.0
10. Tangible assets and software (net of depreciation)	56.2	2.4	-1.6	25.9	1.1	-54.0	19.0	0.5	-26.6
11. Interest, fees and other assets	96.1	4.0	-12.4	48.8	2.1	-49.2	38.9	1.1	-20.3
12. Net of: Specific reserves for unidentified losses	9.0	0.4	13.8	2.6	0.1	-70.6	6.1	0.2	132.3
Total	2,385.3	100.0	51.2	2,371.4	100.0	-0.6	3,521.0	100.0	48.5

Source: CNB.

Deposits were dominant in the liability structure of housing saving banks, totaling HRK 3,265.2m at the end of 2003. Their share in total liabilities reflected an upward trend (from 91.7% at end-2002 to 92.7% at end-2003), rising by 50.1% in nominal terms, primarily on account of deposit growth in housing savings banks. The share of other liability items in total liabilities was negligible.

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

	2001			2002			2003		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Loans from financial institutions	3.5	0.1	-74.1	0.0	0.0	-100.0	0.4	0.0	-
1.1. Short-term loans	2.5	0.1	-79.8	0.0	0.0	-100.0	0.4	0.0	-
1.2. Long-term loans	1.0	0.0	-15.9	0.0	0.0	-100.0	0.0	0.0	-
2. Deposits	1,964.8	82.4	64.1	2,175.3	91.7	10.7	3,265.2	92.7	50.1
2.1. Giro account and current account deposits	6.7	0.3	-3.5	0.3	0.0	-95.3	0.0	0.0	-100.0
2.2. Savings deposits	47.2	2.0	0.7	7.6	0.3	-83.9	0.1	0.0	-98.3
2.3. Time deposits	1,910.9	80.1	67.2	2,167.4	91.4	13.4	3,265.0	92.7	50.6
3. Other loans	2.0	0.1	-54.0	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	-
5. Supplementary capital	28.0	1.2	-46.7	0.0	0.0	-100.0	10.7	0.3	-
5.1. Subordinated instruments issued	3.8	0.2	-51.4	0.0	0.0	-100.0	0.0	0.0	-
5.2. Hybrid instruments issued	24.2	1.0	-45.9	0.0	0.0	-100.0	10.7	0.3	-
6. Interest, fees and other liabilities	85.1	3.6	31.9	45.6	1.9	-46.4	89.9	2.6	97.2
7. Profit/loss for the current year	-29.4	-1.2	-55.5	14.6	0.6	-149.6	-9.3	-0.3	-164.0
8. Capital	331.2	13.9	6.3	135.9	5.7	-59.0	164.1	4.7	20.8
Total	2,385.3	100.0	51.2	2,371.2	100.0	-0.6	3,521.0	100.0	48.5

Source: CNB.

3.7.2 Housing Savings Bank Capital

Total housing savings bank capital amounted to HRK 164.1m at the end of 2003, which was 33% more than at the end of 2002. In the structure of total housing savings bank capital, share capital increased by HRK 10m, i.e. 5.5% compared to 2002. The structure of housing savings bank capital is shown in Table 3.12.

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

	2001			2002			2003		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Share capital	379.4	114.5	11.7	183.4	148.6	-51.7	193.4	117.8	5.5
2. Retained income/loss	-64.7	-19.5	22.4	-73.2	-59.3	13.1	-51.5	-31.3	-29.7
3. Legal reserves	3.6	1.1	-7.9	0.3	0.3	-90.8	1.5	0.9	347.8
4. Reserves provided for by the articles of association and other capital reserves	12.9	3.9	-38.4	12.9	10.4	-0.4	20.7	12.6	61.1
Total	331.2	100.0	22.9	123.4	100.0	-62.7	164.1	100.0	33.0

Source: CNB.

At the end of 2003, regulatory capital of housing savings banks totalled HRK 168.2m, up from HRK 115m as per 31 December 2003. The capital adequacy ratio of housing savings banks stood at 30.5%, compared to 47.2% at the end of 2002. Housing savings banks reported exceptionally high capital adequacy due to low risk-weighted assets (still low credit activity).

3.7.3 Asset Quality of Housing Savings Banks

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

Placements	2001		2002		2003	
	Amount	Share	Amount	Share	Amount	Share
1. Fully recoverable placements	1,653.8	93.4	1,047.3	98.0	2,707.3	100.0
1.1. Group A	1,582.9	89.4	980.9	91.8	2,707.3	100.0
1.2. Group B	70.9	4.0	66.4	6.2	0.0	0.0
2. Partly recoverable placements	79.5	4.5	18.2	1.7	0.2	0.0
2.1. Group C	59.8	3.4	14.1	1.3	0.2	0.0
2.2. Group D	19.7	1.1	4.1	0.4	0.0	0.0
3. Irrecoverable placements	36.6	2.1	3.2	0.3	0.0	0.0
3.1. Group E	36.6	2.1	3.2	0.3	0.0	0.0
Total	1,770.0	100.0	1,068.7	100.0	2,707.5	100.0

Source: CNB.

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

	2001	2002	2003
1. Total provisions for losses	82.5	18.8	6.3
1.1. Placement value impairment (loss)	73.5	16.1	0.1
1.2. Provisions for unidentified losses	9.0	2.7	6.2
2. Total placements	1,770.0	1,073.6	2,717.5
3. Relative ratio of total provisions to total placements	4.7	1.8	0.2

Source: CNB.

At the end of 2003, fully recoverable placements (groups A and B) accounted for 100% of total risk assets of housing savings banks. Therefore, it would not be incorrect to expect a similar trend in the future if we bear in mind the specific loan product these specialised institutions provide.

3.7.4 Housing Savings Bank Earnings Quality

In 2003, housing savings banks reported operating loss of HRK 9.3m. Of four housing savings banks three reported a loss in the total amount of HRK 12m, while one reported a profit of HRK 2.7m.

All income statement items (except non-interest income and net non-interest income) rose in nominal terms compared to 2002. A substantial decrease in net non-interest income of housing savings banks influenced this loss. Housing savings banks have been operating for six consecutive years. Therefore, it is expected that they will register substantial income from interest on loans over the years to come since they will soon start granting housing loans based on housing savings agreements with large contracted amounts, which required a minimum of 5 years of saving.

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

	2001		2002		2003	
	Amount	Change	Amount	Change	Amount	Change
1. Net interest income	90.9	19.6	44.6	-51.0	61.8	38.7
1.1. Interest income	208.6	7.6	114.4	-45.1	152.0	32.8
1.2. Interest expenses	117.7	-0.1	69.9	-40.6	90.2	29.1
2. Net non-interest income	46.8	373.2	70.3	50.3	30.7	-56.4
2.1. Non-interest income	101.3	40.5	117.3	15.8	81.5	-30.5
2.2. Non-interest expenses	54.5	-12.4	47.0	-13.9	50.8	8.3
3. General administrative expenses and depreciation	146.2	11.5	80.9	-44.7	96.8	19.6
4. Net operating income before provisions	-8.5	-81.2	34.0	-499.2	-4.3	-112.7
5. Loan loss provision expenses	11.4	-29.6	6.9	-39.7	4.8	-30.6
6. Pre-tax profit/loss	-19.9	-67.6	27.1	-236.3	-9.1	-133.5
7. Income tax	3.8	-17.9	0.0	-100.0	0.3	
8. After-tax profit/loss	-23.7	-64.1	27.1	-214.4	-9.3	-134.5

Source: CNB.