

Annual Report

2004

CROATIAN NATIONAL BANK

Banking Sector

3

3.1 Characteristics of the Banking Sector

At the end of 2004, the banking sector comprised 37 banking institutions and 4 housing savings banks, which is 4 less than at the end of 2003. The assets of commercial banks made up the dominant 97.8% of total banking sector assets, while the assets of housing savings banks accounted for the remaining 2.2%.

Table 3.1 shows the changes in the number of banking institutions in 2004 and the previous two years. During the course of the year three banks merged with other banks,¹ while one lost its operating licence and became subject to compulsory winding-up proceedings.² These developments resulted in the number of banks reducing from 41 at end-2003 to 37 at end-2004, while the number of housing savings banks remained unchanged.

Table 3.1 Changes in the Number of Banking Institutions
end of period

Banks	2002	2003	2004
Number of banks at the beginning of the year	43	46	41
Banks that merged with other banks	-3	-4	-3
Banks undergoing winding-up proceedings	-	-1	-
Banks whose license was revoked	-	-	-1
Savings banks that were granted bank license	7	-	-
Foreign bank branch removed from the register	-1	-	-
Number of banks at the end of the year	46	41	37
Housing savings banks	2002	2003	2004
Number of housing savings banks at the beginning of the year	4	3	4
Housing savings banks that were granted license	-	1	-
Housing savings banks that merged with other housing savings banks	-1	-	-
Number of housing savings banks (and savings banks) at the end of the year	3	4	4

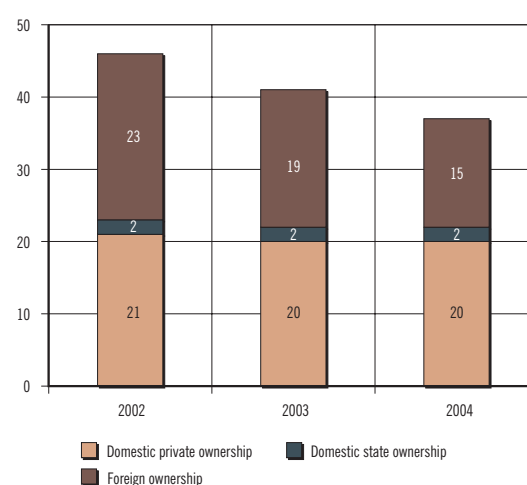
Source: CNB.

The analysis of the structure of banks by ownership residence and form of ownership (Figure 3.1) shows that the total number of banks in 2004 reduced as a consequence of the decrease in the number of banks in majority foreign ownership. The reason for this is to be found in the continuation of the consolidation process in the banking sector and merger of banks with their parent banks. The number of banks in total or majority private ownership of domestic shareholders did not change in 2004.

In the reporting three-year period, the share of banks in majority foreign ownership in total bank assets rose from 90.2% in 2002 to 91.3% in 2004, while the share

3.1

Number of Banks by Ownership
Residence and Form of Ownership
end of period



Source: CNB.

1 Riadria banka d.d., Rijeka merged with Privredna banka Zagreb, d.d. Zagreb, Varaždinska banka d.d., Varaždin merged with Zagrebačka banka d.d., Zagreb, Dubrovačka banka d.d., Dubrovnik merged with Nova banka d.d., Zagreb.

2 Primus banka d.d., Zagreb.

of banks in majority ownership of domestic shareholders (both private and state) reduced to 8.7%, from 9.8% (Table 3.2).

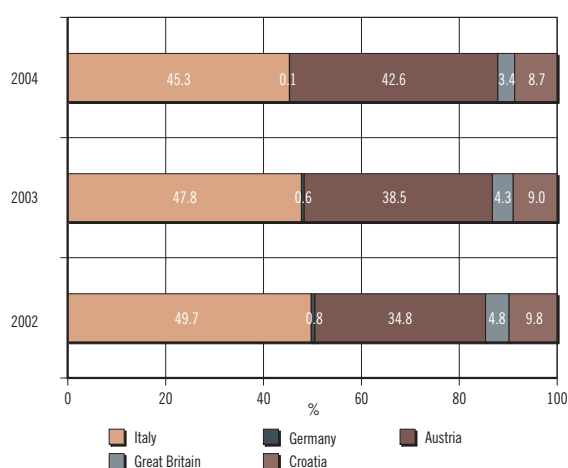
Table 3.2 Bank Assets by Ownership Residence and Form of Ownership
in %

Banks by ownership residence and form of ownership	Share of assets in total bank assets		
	2002	2003	2004
Banks in total or majority private ownership of domestic shareholders	5.8	5.6	5.6
Banks in total or majority state ownership	4.0	3.4	3.1
Banks in total or majority foreign ownership	90.2	91.0	91.3
Total	100.0	100.0	100.0

Source: CNB.

3.2

Bank Assets by Shareholder's Domicile^a
end of period



^a For the purpose of this overview the shareholder's domicile means the head office of a company or residence of the owner (a natural person).

Source: CNB.

In 2004, the largest number of banks was owned by Italian shareholders (7 banks), with the assets of these banks making up 45.3% of total bank assets in 2004. Six banks were owned by Austrian shareholders, while one was owned by German shareholders and one by shareholders from Great Britain (Figure 3.2).

Table 3.3 shows the number of banks classified in peer groups by asset size and the share of each group in total bank assets. The data presented in the Table show that the largest banks, belonging to Group I (banks with assets exceeding HRK 5bn), have been increasing their share in total bank assets year after year. This group also saw a 22.5% assets rise in 2004 as compared to 2003, while its share in total bank assets increased from 82.9% in 2003 to 90.0% in 2004. By the size of their assets, the two largest banks from Group I dominate the banking sector, accounting for 43.2% of total bank assets.

The number of banks in Group I increased from 8 to 9 in 2004. The total assets of this group of banks went up as compared to 2003 in consequence of the increase in the number of banks in this group, as well as of the growth in assets of individual banks and the merger of three Group II banks with Group I banks.

The number of banks with assets ranging from HRK 1bn to HRK 5bn (Group II) declined from 11 to 7 in 2004, with their share in total bank assets falling from 12.5 % to 5.7%. The total assets of Group II banks went down as compared to 2003 in consequence of the abovementioned mergers as well as one bank switching to Group I due to asset growth. Groups III and IV, totalling 21 banks and comprising banks with assets below HRK 1bn and 0.5bn respectively, accounted for only 4.3% of total bank assets at the end of 2004.

In 2004, there were four banking groups operating in the banking sector of the Republic of Croatia and reporting to the CNB on their operations in accordance with the provisions of the Decision on Consolidated Financial Reports of a

Table 3.3 Bank Groups by Asset Size
end of period, in million HRK and %

Assets		Number of banks			Share of assets of peer groups of banks in total bank assets		
		2002	2003	2004	2002	2003	2004
Group I	Assets exceeding 5,000	9	8	9	79.6	82.9	90.0
Group II	Assets from 1,000 to 5,000	12	11	7	15.2	12.5	5.7
Group III	Assets from 500 to 1,000	7	8	10	2.7	2.7	3.2
Group IV	Assets below 500	18	14	11	2.5	1.9	1.1
Total		46	41	37	100.0	100.0	100.0

Banking Group.³ The superordinate banks of these groups are as follows: Zagrebačka banka d.d., Zagreb, Privredna banka Zagreb d.d., Zagreb, Raiffeisenbank d.d., Zagreb and Nova banka d.d., Zagreb.

The competition among banks has been intensifying, which is reflected in further interest rate reductions, liberalisation of loan approval terms and increase in available banking products especially tailored to appeal to different market segments. One of the novelties introduced in 2004 are housing savings loans indexed to the Swiss franc, which enabled the approval of housing savings loans at nominally lower rates. However, the structure of total net loans approved in or indexed to a foreign currency was dominated by loans approved in or indexed to the euro, which accounted for a 91.6% share, while loans approved in or indexed to the Swiss franc made up only 3.8% of total net loans approved in or indexed to foreign currency in 2004.

The speedy growth of bank assets has been regulated by a new Decision on the Classification of Placements and Contingent Liabilities of Banks⁴ in effect as of the beginning of 2004. A part of this Decision substituted a previous monetary measure that obligated banks to subscription of low-yield CNB bills. In accordance with the new Decision, banks are obligated to form and maintain additional reserves for general bank risks if the growth of specific items of their assets and specific items of their off-balance contingent liabilities exceeds 20%. Exceptionally, banks are not required to form reserves for general bank risks if they have the required capital adequacy ratio.

In 2004, the CNB continued efforts directed at establishing co-operation with supervisory authorities of foreign banks owning Croatian banks as well as banks owned by Croatian banks. In addition to the Memorandum of Understanding and Co-operation in Banking Supervision being signed with the agency responsible for bank supervision in Bosnia and Herzegovina in 2003, positions on future co-operation with authorities responsible for bank supervision in Austria and Italy were harmonised in 2004.

³ Official gazette *Narodne novine*, No. 17/2003.

⁴ Official gazette *Narodne novine*, No. 17/2003.

New Subordinate Legislation

New subordinate legislation (decisions and accompanying instructions) passed by the CNB pursuant to the Banking Act⁵ in 2003, has been in force as of 1 January 2004. The said decisions and instructions regulate the exposure of banks to particular types of risks, reporting requirements as well as the conditions for providing banking and other financial services. The starting point in their creation was harmonisation with EU guidelines, compliance with recommendations of the Basel Committee for Bank Supervision, International Accounting Standards (IAS 32 and IAS 39) as well as other regulations in force in the Republic of Croatia.

3.2 Balance Sheet Structure of Banks

3.2.1 Bank Asset Structure

Bank assets totalled HRK 230.2bn⁶ at the end of 2004, up 12.8% on the end of 2003 when total bank assets stood at HRK 204.1bn (Table 3.4). Of the total number of banks, 33 saw their assets grow, while of the remaining four whose assets reduced one is in the process of being merged with another bank and one is undergoing winding up proceedings.

Net loans to other clients (non-financial sector) realised the largest absolute growth in the structure of bank assets, totalling HRK 121.9bn at the end of 2004, up HRK 14.9bn or 14.3% compared to the end of 2003. Their share in the structure of bank assets increased from 52.3% at end-2003 to 53% at end-2004.

Total net loans grew at a rate exceeding 20% at 14 banks. The six largest banks,⁷ whose share in total bank assets stood at 81.8% at end-2004, accounted for 88.1% of the increase in total loans in nominal terms, reflecting their dominant market position. A decline in approved loans, in nominal terms, was registered at eight banks, of which five belong to Group IV banks by their asset size.

Figure 3.3, which shows net loans by type of user, indicates that in 2004, the same as over the previous years, banks directed their lending activities at households. Household loans predominated in the structure of net loans in Group I (49.9%), Group II (56.1%) and Group IV (52.2%) as evident from Figure 3.4, while corporate loans, with a share of 54.5% predominated in the structure of net loans in Group III. Net household loans grew at a faster rate (19.1%) than total net loans

⁵ Official gazette *Narodne novine*, No. 84/2002.

⁶ All financial data are based on preliminary unaudited bank reports for 2004.

⁷ Zagrebačka banka d.d., Zagreb, Privredna banka Zagreb d.d., Zagreb, Erste & Steiermärkische Bank d.d., Rijeka, Raiffeisenbank Austria d.d., Zagreb, HVB Splitska banka d.d., Split and HYPO Alpe-Adria-Bank d.d., Zagreb.

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

	2002			2003			2004		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Money assets and deposits with the CNB	21,387.9	12.3	-3.6	28,002.6	13.7	30.9	34,891.3	15.2	24.6
1.1. Money assets	2,236.9	1.3	-71.4	2,955.6	1.4	32.1	3,062.1	1.3	3.6
1.2. Deposits with the CNB	19,151.0	11.0	33.2	25,047.0	12.3	30.8	31,829.2	13.8	27.1
2. Deposits with banking institutions	20,146.2	11.6	-16.0	31,186.6	15.3	54.8	33,351.1	14.5	6.9
3. MoF treasury bills and CNB bills	10,116.7	5.8	4.4	7,820.7	3.8	-22.7	3,580.6	1.6	-54.2
4. Securities and other financial instruments held for trading and available for sale	9,023.2	5.2	59.2	7,784.9	3.8	-13.7	16,449.9	7.1	111.3
4.1. Securities and other financial instruments held for trading	0.0	0.0	0.0	0.0	0.0	0.0	6,545.9	2.8	0.0
4.2. Securities and other financial instruments available for sale	0.0	0.0	0.0	0.0	0.0	0.0	9,903.9	4.3	0.0
5. Securities and other financial instruments held to maturity and bought on issue directly from the issuer	12,531.7	7.2	3.9	10,773.3	5.3	-14.0	7,569.4	3.3	-29.7
5.1. Securities and other financial instruments held to maturity	0.0	0.0	0.0	0.0	0.0	0.0	6,566.4	2.9	0.0
5.2. Securities and other financial instruments bought on issue directly from the issuer	0.0	0.0	0.0	0.0	0.0	0.0	1,003.0	0.4	0.0
6. Derivative financial assets	0.0	0.0	0.0	0.0	0.0	0.0	152.0	0.1	0.0
7. Loans to financial institutions	2,157.8	1.2	45.8	3,057.0	1.5	41.7	3,289.5	1.4	7.6
8. Loans to other clients	89,673.9	51.5	39.9	106,730.6	52.3	19.0	121,975.9	53.0	14.3
9. Investments in subsidiaries and associates	2,448.2	1.4	11.3	2,456.0	1.2	0.3	1,711.0	0.7	-30.3
10. Foreclosed and repossessed assets	375.4	0.2	-16.0	355.4	0.2	-5.3	343.4	0.1	-3.4
11. Tangible assets (net of depreciation)	3,755.4	2.2	7.3	4,094.6	2.0	9.0	3,755.5	1.6	-8.3
12. Interest, fees and other assets	4,042.3	2.3	-5.4	3,603.6	1.8	-10.9	5,220.3	2.3	44.9
13. Net of: Specific reserves for unidentified losses	1,519.4	0.9	27.1	1,750.2	0.9	15.2	1,997.5	0.9	14.1
Total assets	174,139.2	100.0	17.3	204,115.0	100.0	17.2	230,292.4	100.0	12.8

Source: CNB.

(13.8%), reaching HRK 62.3bn in 2004, up by over HRK 10.1bn as compared to 2003.

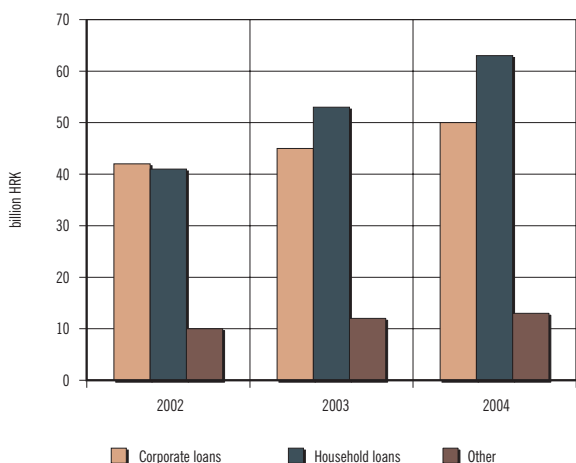
Five of nine banks from Group I extended predominantly household loans, while the remaining four, including the one in majority state ownership granted predominantly corporate loans. Movements in the loan structure of this group largely contributed to the share of household loans in total bank loans increasing from 47.7% at end-2003 to 50% at end-2004. Regardless of the growth of corporate loans in nominal terms, their share in total bank loans reduced from 41.1% in 2003 to 39.6% in 2004.

The share of other loans, including loans to financial institutions, government units, non-profit institutions and non-residents, accounted for 10.4% of total loans in 2004, having realised the most prominent share (11.9%) in total loans of Group I banks. The share of other loans in total loans of other groups ranged from 1.6% in Group IV to 6% in Group II.

Bank asset structure reflects a continuance of the strong growth of deposits with the CNB, which grew by 27.1% in 2004 as compared to 2003 and 66.1% as compared to 2002. The lion's share of these deposits (78.4%) was made up of reserve requirements allocated with the CNB, which rose by 29.4% on the previous year.

3.3

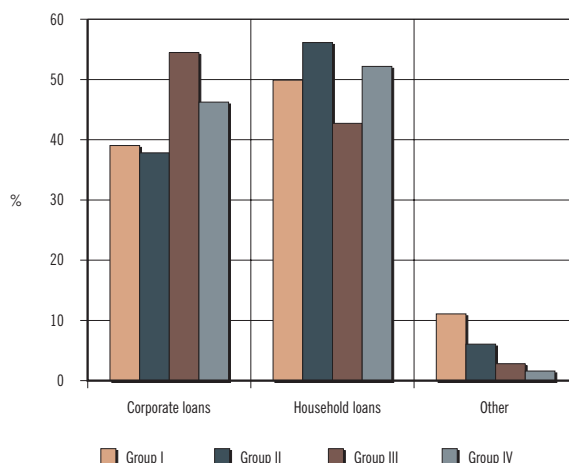
Net Loans by Type of User
end of period



Source: CNB.

3.4

Structure of Net Loans by Peer Groups of Banks
end-2004



Source: CNB.

In addition to the increase in reserve requirement calculation base a strong contribution to this rise came from the introduction of a new monetary measure – the marginal reserve requirement. The decision on the introduction of the marginal reserve requirement instrument was adopted in July 2004. In August, banks allocated for the first time the calculated marginal reserve requirement to a special account with the CNB. As over the previous periods, banks substantially reduced their investments in T-bills in 2004, which saw no CNB bills issues. Banks increased their investments in securities and other financial instruments held for trading and available for sale in 2004, which thus grew by 111.3% on the year before. Investments in subsidiaries and associates reduced as a result of three banks merging with other banks in 2004.

Derivative financial assets accounted for only 0.1% of the bank asset structure at-end 2004. However, the contracted value of derivative financial instruments shown in banks' off-balance sheet records totalled HRK 23.8bn and made up 10.3% of bank assets. The major portion of contracted derivative financial instruments (74.9%) is intended for trading, while embedded derivatives and derivative instruments used as hedging instruments account for the remaining shares with 25% and 0.1% respectively. Derivatives with the exchange rate as the related variable dominate the total contracted value of derivative financial instruments with a share of 69.1%.

3.2.2 Bank Liability Structure

Deposits predominated in the bank liability structure at the end of 2004, accounting for 67.4% of total liabilities. Capital made up 8.6% and other sources 24.0%. The liability structure depended on the bank size (Figure 3.5). The share of capital in the liability structure of Group I and Group II banks was relatively small (8.1% and 8.5% respectively), with other sources of funds accounting for more substantial shares, in contrast to Group II and Group IV banks.

Deposits grew by 11.6bn or 8.1% in nominal terms (Table 3.5). However, as a result of total deposits growing slower than received loans their share reduced to 67.4%, from 70.4% at the end of 2003. The shares of all types of deposits in total liabilities also reduced, with all groups of banks registering similar shares ranging from 64.3% to 70.6% (Figure 3.5). As over the previous years, the majority of deposits were denominated in foreign currency (67.2%).

At 15 banks deposits grew at rates exceeding 20%, while 6 banks registered their decline as compared to 2003. The six leading banks accounted for 68.5% of the growth in nominal terms. Household deposits continued dominating the deposit base of commercial banks with a share of 56%. The lion's share of household deposits, totalling HRK 59.3bn or 78.2%, was made up of time deposits, followed by savings deposits with a share of HRK 19.7bn. The largest contribution to total growth of time deposits reaching HRK 10.9bn or 11.6% came from the HRK 6.8bn increase in household time deposits. They accounted for 58.7% of the total nominal growth, with their share in total deposits going up from 55.3% to 56%.

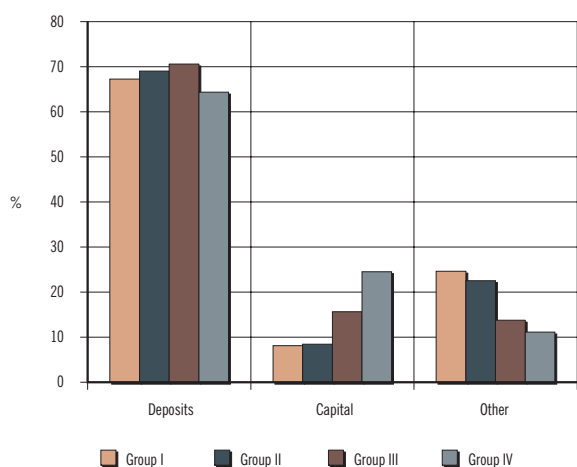
Total received loans (loans from financial institutions and other loans) grew at a rate of 23.7%, accounting for 17.3% of total liabilities in 2004. The lion's share of total loans was received from foreign financial institutions (76.9%) and the CBRD (11.4%). Other received loans went up 25.1% on the end-2003, while loans from financial institutions grew by 19% (Table 3.5). Maturities of 77.8% of total received loans were longer than 1 year.

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

	2002			2003			2004		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Loans from financial institutions	4,084.6	2.3	12.6	7,112.9	3.5	74.1	8,462.0	3.7	19.0
1.1. Short-term loans	1,184.4	0.7	98.8	3,689.1	1.8	211.5	3,592.1	1.6	-2.6
1.2. Long-term loans	2,900.2	1.7	-4.4	3,423.8	1.7	18.1	4,869.9	2.1	42.2
2. Deposits	124,471.8	71.5	18.9	143,692.8	70.4	15.4	155,277.5	67.4	8.1
2.1. Giro account and current account deposits	23,272.3	13.4	40.6	25,285.1	12.4	8.6	25,560.0	11.1	1.1
2.2. Savings deposits	23,980.0	13.8	-9.1	24,770.7	12.1	3.3	25,223.3	11.0	1.8
2.3. Time deposits	77,219.6	44.3	25.0	93,637.0	45.9	21.3	104,494.2	45.4	11.6
3. Other loans	19,492.6	11.2	22.2	25,080.3	12.3	28.7	31,368.3	13.6	25.1
3.1. Short-term loans	4,451.2	2.6	649.4	3,429.0	1.7	-23.0	5,265.3	2.3	53.6
3.2. Long-term loans	15,041.4	8.6	-2.0	21,651.3	10.6	43.9	26,103.0	11.3	20.6
4. Derivative financial liabilities and other financial liabilities held for trading	-	-	-	-	-	-	260.1	0.1	0.0
5. Debt securities issued	24.7	0.0	27.6	97.0	0.0	0.0	3,535.0	1.5	3,543.8
5.1. Short-term debt securities issued	5.2	0.0	0.0	0.0	0.0	-100.0	0.0	0.0	0.0
5.2. Long-term debt securities issued	19.6	0.0	1.0	97.0	0.0	395.3	3,535.1	1.5	3,543.9
6. Subordinated instruments issued	641.3	0.4	89.0	813.6	0.4	26.9	818.3	0.4	0.6
7. Hybrid instruments issued	2,268.9	1.3	-2.1	2,261.6	1.1	-0.3	1,642.8	0.7	-27.4
8. Interest, fees and other liabilities	6,646.4	3.8	-14.6	6,899.4	3.4	3.8	9,174.4	4.0	33.0
Total liabilities	157,630.4	90.5	17.0	185,957.6	91.1	18.0	210,538.4	91.4	13.2
Total capital	16,508.8	9.5	20.5	18,157.3	8.9	10.0	19,753.9	8.6	8.8
Total liabilities and capital	174,139.2	100.0	17.3	204,115.0	100.0	17.2	230,292.4	100.0	12.8

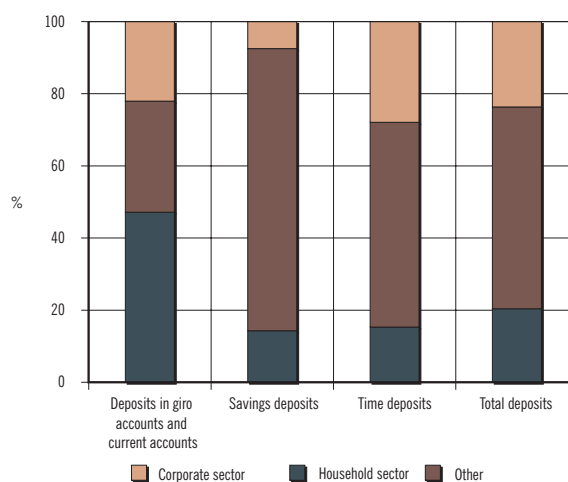
Source: CNB.

3.5

Liability Structure by Peer Groups of Banks
end-2004

Source: CNB.

3.6

Structure of Deposits by Type and Sector
end-2004

Source: CNB.

While debt securities issued by banks registered a substantial growth in nominal terms as compared to 2003, hybrid instruments reduced as a result of their transfer into share capital.

3.3 Bank Capital

At the end of 2004, bank capital totalled HRK 19.8bn, rising 8.8% as compared to end-2003 (Table 3.6). This was mostly due to higher current year profit and retained earnings. Share capital went up by 1.7% (HRK 167.5bn in nominal terms). Over the previous years, share capital has been reducing in total banking capital which continued in 2004, when share capital accounted for 51.2% of total capital.

At end-2004, banks' regulatory capital totalled HRK 19.5bn, up 1.3% as compared to end-2003 when it stood at HRK 19.3bn (Figure 3.7). The method for calculating regulatory capital was amended by the Decision on the Capital Adequacy of Banks,⁸ applied as of the beginning of 2004. In accordance with the provisions of this new decision regulatory capital is the sum of core capital, supplementary capital I and supplementary capital II. Although core capital (reduced by deduction items) grew by 0.1% on 2003, due to a more sizable growth of supplementary capital I, which is included in regulatory capital, the share of core capital in gross regulatory capital continued declining. At end-2004, core capital (reduced by deduction items) made up 80.2% of gross regulatory capital. Supplementary capital I accounted for 19.8% of gross regulatory capital, while the share of supplementary capital II was at a negligible 0.01%.

⁸ Official gazette *Narodne novine*, Nos. 17/2003, 120/2003, 195/2003 and 39/2004.

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

	2002			2003			2004		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Share capital	9,772.1	59.2	9.0	9,945.6	54.8	1.8	10,113.1	51.2	1.7
2. Current year profit/loss	1,925.5	11.7	237.8	2,351.6	13.0	22.1	3,141.8	15.9	33.6
3. Retained earnings/loss	860.3	5.2	1,006.0	1,415.0	7.8	64.5	1,899.0	9.6	34.2
4. Legal reserves	583.5	3.5	-31.6	711.2	3.9	21.9	718.1	3.6	1.0
5. Total reserves provided for by the articles of association and other capital reserves	3,367.4	20.4	13.5	3,824.0	21.1	13.6	3,882.7	19.7	1.6
5.1. Reserves provided for by the articles of association and other capital reserves	3,367.4	20.4	13.5	3,824.0	21.1	13.6	3,885.4	19.7	1.6
5.2. Unrealised gains/losses on value adjustment of financial assets available for sale	0.0	0.0	0.0	0.0	0.0	0.0	-2.8	0.0	0.0
5.3. Reserves arising from hedging transactions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
6. Previous year profit/loss	0.0	0.0	0.0	-90.1	-0.5	0.0	-0.7	0.0	-99.2
Total capital	16,508.8	100.0	20.5	18,157.3	100.0	10.0	19,753.9	100.0	8.8

Source: CNB.

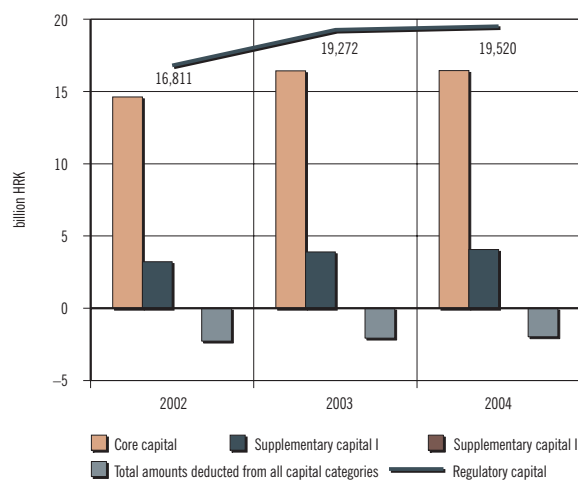
Although their regulatory capital went up, banks' capital adequacy ratio reduced from 16.24% at end-2003 to 14.10% at end-2004. The reason for the continuation of the decline in the capital adequacy ratio which started over previous years is to be found in faster growth of risk-weighted assets over regulatory capital. In addition, the decline in capital adequacy ratio was also influenced by the application of the Decision on the Capital Adequacy of Banks pursuant to which, for the purpose of calculating the capital adequacy ratio, risk-weighted assets are increased by the overall foreign exchange position exposure to currency risk, by the capital requirement for position risks, by the capital requirement for settlement/counterparty risk and by the capital requirement for exceeding the permissible exposure limit. Of the total number of banks, eight banks calculated the capital adequacy ratio by applying the comprehensive approach.

At end-2004, all banks posted capital adequacy ratios at levels exceeding the minimum statutory limit of 10%. Capital adequacy ratio of Group I banks was the lowest at 13.56%, having declined from the previous year. With a share of 90% in total bank assets this group of banks had the strongest influence on the capital adequacy at banking sector level, while other groups of banks registered capital adequacy ratios exceeding the one at sector level (Figure 3.9). The highest capital adequacy ratio was registered by Group IV banks.

Risk-weighted assets went up 14.4% as compared to 2003. In the risk-weighted asset structure assets

3.7

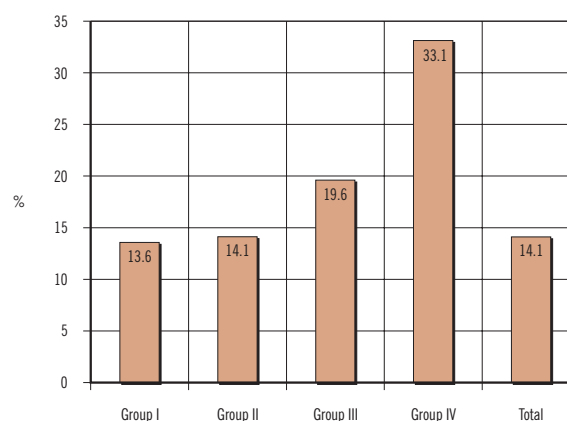
Structure of Bank Regulatory Capital
end of period



Source: CNB.

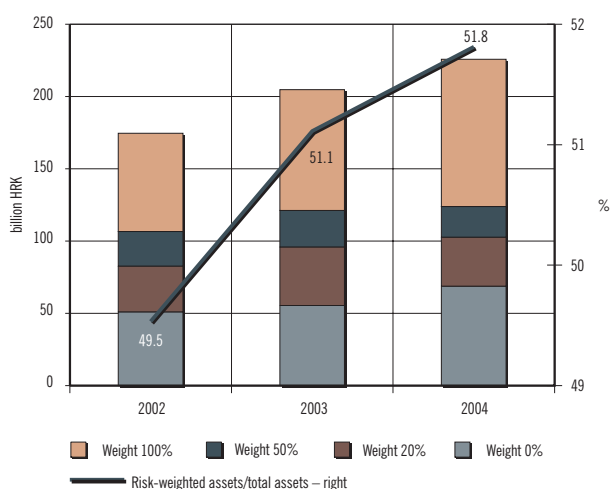
3.8

Capital Adequacy Ratio
by Peer Groups of Banks
end-2004



Source: CNB.

3.9

Bank Assets Included in Risk-Weighted Assets
end of period

Source: CNB.

bearing the highest risk (risk-weight of 100%) visibly increased. At end-2004, they accounted for 44.3% of total bank assets (Figure 3.9). The share of assets with the risk-weight of 0% also increased, making up 29.9% of total assets. As a result of the rise in shares of items bearing higher credit risk in total assets, it also came to the increase in the ratio of total risk-weighted assets to total assets, which stood at 51.8% at end-2004.

3.4 Bank Asset Quality

As of 1 January 2004, the quality of bank assets and off-balance contingent liabilities is assessed in accordance with the new Decision on the Classification of Placements and Contingent Liabilities of Banks. The decision proscribes the criteria for the classification of placements and off-balance sheet contingent liabilities on the basis of which banks are exposed to credit risk, into corresponding risk groups, as well as the method of forming loan loss provisions related to credit risk and determining credit exposure of banks. Banks regulate the determination and monitoring of creditworthiness of persons to which a bank is exposed, as well as the quality of instruments of collateral, keeping of credit records and records of assumed contingent liabilities, classification of placements and contingent liabilities into risk groups, provisioning for identified and unidentified losses by their by-laws.

Depending on a debtor's creditworthiness, timeliness in meeting their obligations and collateral quality, bank placements and off-balance sheet contingent liabilities are classified into three basic risk groups. Risk group A comprises fully recoverable placements, which are assessed with certainty as fully recoverable. Risk category B with sub-categories B1, B2, and B3 encompasses partly recoverable placements for which it is assessed that they will not be fully recovered. Risk category C comprises fully irrecoverable placements, which are assessed as fully irrecoverable or recoverable only to an insignificant amount. Group B and C placements are subject to value impairment. Total placements and contingent liabilities of group A are used as the basis for calculation of provisions for unidentified losses at a rate which in accordance with the policy of each bank may range from 0.85% to 1.20%.

Increase in lending combined with quality new debtors and adequate instruments of collateral contributed to the increase of fully recoverable placements (group A) which increased by 15.7% as compared to 2003 and accounted for 95.5% of total

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

Placements	2002		2003		2004	
	Amount	Share	Amount	Share	Amount	Share
Fully recoverable placements	172,251.3	94.1	200,166.3	94.9	231,593.0	95.5
Partly recoverable placements	6,473.3	3.5	7,475.8	3.5	6,582.8	2.7
Irrecoverable placements	4,245.4	2.3	3,371.5	1.6	4,359.2	1.8
Total	182,970.0	100.0	211,013.6	100.0	242,535.0	100.0

Source: CNB.

Table 3.8 Value Adjustment and Bank Provisions
end of period, in million HRK and %

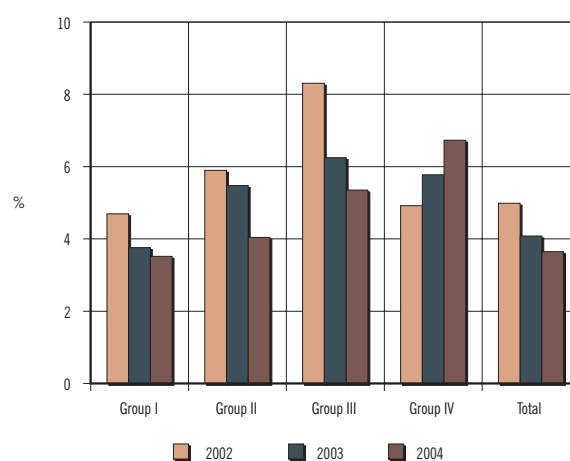
	2002	2003	2004
Total value adjustment against placements and provisions for contingent liabilities	9,121.2	8,611.5	8,837.5
– value adjustment against placements	7,303.4	6,573.8	6,598.3
– provisions for unidentified losses	1,817.9	2,037.7	2,239.2
Total placements and contingent liabilities	182,970.0	211,013.6	242,535.0
Relative ratio of total value adjustment and provisions to total placements and contingent liabilities	5.0	4.1	3.6

Source: CNB.

placements (Table 3.7). Partly recoverable placements (group B) decreased in nominal terms on the year before with their share reducing to 2.7% of total placements. At the same time, irrecoverable placements (group C) increased in nominal terms thus increasing their share in total placements. As a result, the share of total bad placements (groups B and C) in total gross placements reduced to 4.5%, the lowest ratio in the past three years. Total value impairments and provisions for contingent liabilities, which include provisions for unidentified losses, went up by 2.6% (Table 3.8) on 2003, thus reversing the previously observed downward trend in nominal terms. However, resulting from the increased rate of growth of placements and contingent liabilities (14.9%) and better quality of positions exposed to credit risk their share in total placements continued falling: from 5% in 2002 to 4.1% in 2003 and 3.6% in 2004. Of all groups of banks only Group IV banks increased the coverage of placements and contingent liabilities by value impairment and provisions, which totalled 6.7% at the end of 2004 (Figure 3.10).

3.10

Placements and Contingent Liabilities to Value Adjustment and Provisions Ratio
by peer groups of banks, end of period



Source: CNB.

3.5 Bank Earnings Quality

In 2004, banks reported a pre-tax profit of HRK 3,692.8m. Of the total number of banks, 35 earned pre-tax profit of HRK 3,728.7m, while two banks, one having merged with another bank and one having wound-up its operations posted losses in the total amount of HRK 35.9m.

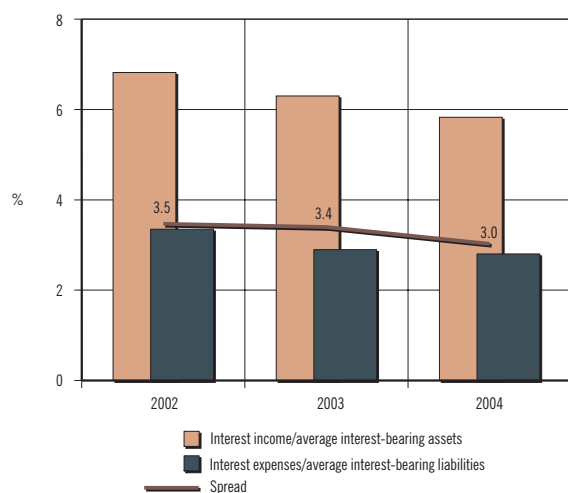
Table 3.9 Bank Income Statement
in million HRK and %

	2002		2003		2004	
	Amount	Change	Amount	Change	Amount	Change
Total interest income	9,919.4	9.6	11,093.7	11.8	11,825.0	6.6
Total interest expenses	4,655.0	6.3	4,784.2	2.8	5,368.3	12.2
Net interest income	5,264.4	12.7	6,309.5	19.9	6,456.8	2.3
Total income from commissions and fees	2,611.2	50.3	3,010.5	15.3	3,082.5	2.4
Total expenses on commissions and fees	1,238.8	192.9	1,528.4	23.4	1,440.6	-5.7
Net income from commissions and fees	1,372.5	4.4	1,482.1	8.0	1,641.9	10.8
Other non-interest income	1,580.1	29.6	1,493.8	-5.5	1,818.6	21.7
Other non-interest expenses	693.1	-55.6	788.2	13.7	617.5	-21.7
Net other non-interest income	887.0	-359.2	705.6	-20.4	1,201.1	70.2
Net non-interest income	2,259.5	132.5	2,187.8	-3.2	2,843.1	30.0
General administrative expenses and depreciation	4,427.2	12.4	4,831.8	9.1	5,055.3	4.6
Net operating income before loss provisions	3,096.6	81.5	3,665.5	18.4	4,244.5	15.8
Expenses on value adjustment and provisions for identified losses	156.0	-232.3	435.6	179.2	333.6	-23.4
Expenses on provisions for unidentified losses	395.9	-33.9	219.3	-44.6	218.1	-0.5
Total expenses on loss provisions	551.9	14.7	654.8	18.7	551.7	-15.7
Income/loss before taxes	2,544.8	107.8	3,010.7	18.3	3,692.8	22.7
Income tax	470.0	38.5	504.0	7.2	551.0	9.3
Current year profit/loss	2,074.8	134.4	2,506.7	20.8	3,141.8	25.3

Source: CNB.

3.11

Income from Interest-Bearing Assets and Expenses on Interest-Bearing Liabilities end of period

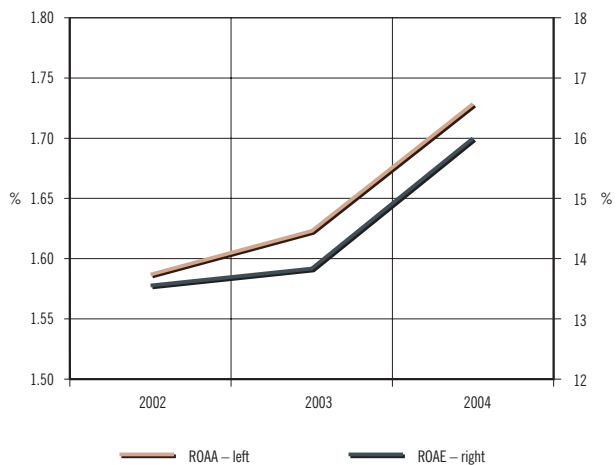


Source: CNB.

As compared to previous years, when it saw much higher growth rates (Table 3.9), at the end of 2004 net interest income grew only 2.33% on a year ago. However, average interest income (interest income measured in relation to average interest-bearing assets) declined from 6.3% in 2003 to 5.8% in 2004 (Figure 3.11). At the same time, average interest expenses (interest expenses measured in relation to average interest-bearing liabilities) registered a smaller decline than average interest income (from 2.9% to 2.8%) thus reducing the spread.

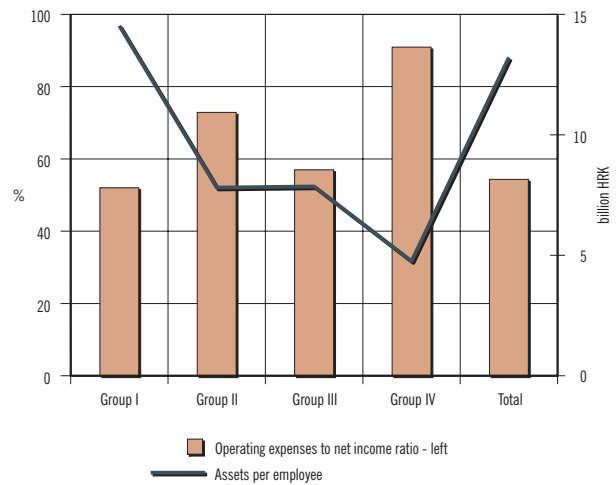
A sizeable reduction in non-interest expenses (11.2%) and a rise in non-interest income (15.7%) led to a faster growth of net non-interest income, which increased by 29.9%. The largest contribution to the rise of non-interest income came from the earnings from

3.12

Return on Average Assets and Return on Average Equity
end of period

Source: CNB.

3.13

Operating Efficiency by Peer Groups of Banks
end-2004

Source: CNB.

securities trading and equity investment. Net operating income before loss provisions went up 15.8% as compared to the previous year.

Expenses for loan loss provisions reduced by 15.8%, due among other things to the predominant share of less risky household loans in total newly approved loans. Income after tax increased by 25.3% as compared to 2003 thus pushing up the profitability indicators. Return on average assets went up from 1.59% at the end of 2003 to 1.70 at the end of 2004, while the return on average equity rose from 14.46% to 16.57% (Figure 3.12). The largest impact on the efficiency of the entire banking sector came from large banks belonging to Group I banks, which managed their resources more successfully than banks in other three groups, thus generating 94.1% of income before tax (Figure 3.13).

3.6 Bank Liquidity

The banking sector was liquid in 2004, with banks having no problems in servicing their obligations. Received deposits totalled HRK 15.5bn at the end of 2004, up 8.1% from 2003, while, at the same time, extended loans increased by 13.8%. The ratio of total deposits to total loans increased from 76.6% to 80.7%.

Total received loans in 2004 increased by 23.7% as compared to 2003. Since their growth outstripped the growth of assets, the ratio of received loans to total assets increased from 15.8% at end-2003 to 17.3% at end-2004 (Table 3.10). Foreign financial institutions accounted for the largest share of received loans (75.5%), while loans from foreign majority owners made up 27.5% of bank financing. The increase in loans received from financial institutions contributed to a rise in net interbank position,⁹ which went up from 13.2% to 15.3% in 2004.

⁹ The difference between assets placed with financial institutions and assets received from financial institutions relative to total assets.

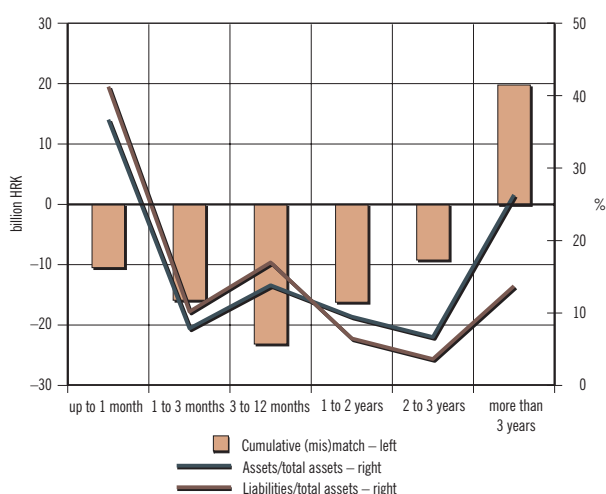
Table 3.10 Bank Liquidity Ratios
end of period, in %

	2002	2003	2004
Received deposits/extended loans	74.1	76.6	80.7
Received loans/total assets	13.5	15.8	17.3
Net interbank position	10.7	13.2	15.3

Source: CNB.

3.14

Bank Assets/Liabilities Match by Maturity
end-2004



Source: CNB.

Banks maintain and adjust assets and liabilities by maturity structure for liquidity management purposes. Maturity structure (mis)match represents the difference between net assets and liabilities (not including capital) with the same period until maturity. At end-2004, short-term liabilities with maturity in up to one year exceeded short-term assets, with 85.3% of banks' short-term liabilities being covered by short-term assets. Liabilities with the shortest time until maturity (up to one month) exceeded assets by HRK 10.4bn, which made up 4.6% of total assets. The cumulative mismatch, totalling HRK 23.1bn, was largest at the end of short-term period (Figure 3.14). In the long-term (remaining period until maturity exceeding one year) banks assets started exceeding their liabilities, thus reducing the cumulative mismatch.

3.7 Performance of Housing Savings Banks

At the end of 2004, total assets of housing savings banks amounted to HRK 5.2bn, up 48.4% on 2003. The number of housing saving banks operating in the Republic of Croatia remained unchanged with 4 housing savings banks being present in the market, same as in 2003. Although housing savings banks account for only 2.2% of total bank assets, individual housing saving banks surpassed many commercial banks by the size of their assets. If they were banks, the assets size of two housing saving banks, which in each case exceeds HRK 2bn, would place them in the second group of peer banks, while the remaining savings banks would belong to Group III or Group IV.

3.7.1 Balance Sheet Structure of Housing Savings Banks

At the end of 2004, securities and other financial instruments available for sale accounted for the largest share (41.1%) in total assets of housing savings banks,

followed by T-bills (14.9%) and securities and financial instruments held until maturity (10.5%) and loans to financial institutions (9.0%). Securities, that is, bonds and other long-term debt instruments issued by the Republic of Croatia and central government funds dominated the securities portfolios. Investments in securities available for sale included investments in bonds and other long-term instruments issued by the Republic of Croatia (94.3%) as well as bonds and other long-term debt instruments issued by central government funds (3.9%), with investments in bonds and other long-term instruments of the CBRD and banks accounting for the remaining share.

Table 3.11 Structure of Housing Savings Bank Assets

end of period, in million HRK and %

	2002			2003			2004		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Money assets and deposits with the CNB	19.1	0.9	23.7	0.0	0.0	-100.0	0.0	0.0	0.0
1.1. Money assets	0.0	0.0	-33.3	0.0	0.0	-56.3	0.0	0.0	0.0
1.2. Deposits with the CNB	19.1	0.9	23.8	0.0	0.0	-100.0	0.0	0.0	0.0
2. Deposits with banking institutions	27.2	1.2	192.9	25.9	0.7	-4.9	332.4	6.4	1,185.5
3. MoF treasury bills and CNB bills	561.5	25.7	38.7	748.9	21.3	33.4	780.8	14.9	4.3
4. Securities and other financial instruments held for trading and available for sale	1,149.6	52.6	145.3	766.8	21.8	-33.3	2,398.1	45.9	212.7
4.1. Securities and other financial instruments held for trading	-	-	-	-	-	-	250.2	4.8	-
4.2. Securities and other financial instruments available for sale	-	-	-	-	-	-	2,148.0	41.1	-
5. Securities and other financial instruments held to maturity and bought on issue directly from the issuer	277.8	12.7	-17.2	1,527.9	43.4	450.1	623.1	11.9	-59.2
5.1. Securities and other financial instruments held to maturity	-	-	-	-	-	-	548.2	10.5	-
5.2. Securities and other financial instruments bought on issue directly from the issuer	-	-	-	-	-	-	75.0	1.4	-
6. Derivative financial assets	-	-	-	-	-	-	0.0	0.0	-
7. Loans to financial institutions	10.1	0.5	13.8	211.4	6.0	2,002.7	469.0	9.0	121.8
8. Loans to other clients	91.3	4.2	688.0	187.8	5.3	105.6	372.9	7.1	98.6
9. Investments in subsidiaries and associates	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-
10. Foreclosed and repossessed assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-
11. Tangible assets (net of depreciation)	20.5	0.9	2.8	19.0	0.5	-7.4	8.7	0.2	-54.0
12. Interest, fees and other assets	30.8	1.4	23.1	39.1	1.1	27.1	261.6	5.0	569.0
13. Net of: Specific reserves for unidentified losses	1.6	0.1	396.8	6.3	0.2	297.8	23.1	0.4	269.1
Total assets	2,186.3	100.0	68.3	3,520.4	100.0	61.0	5,223.5	100.0	48.4

Source: CNB.

Time deposits were dominant in the liability structure of housing savings banks at the end of 2004 with a share of 90.5%, followed by interests, fees and other liabilities (6.2%) and capital (3.0%). Although time deposits registered the biggest increase of HRK 1.5bn in nominal terms, their share in total liabilities of housing savings banks reduced by 2.2 percentage points, to 90.5% at the end of 2004.

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

	2002			2003			2004		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Loans from financial institutions	0.0	0.0	0.0	0.4	0.0	0.0	0.0	0.0	-100.0
1.1. Short-term loans	0.0	0.0	0.0	0.4	0.0	0.0	0.0	0.0	-100.0
1.2. Long-term loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2. Deposits	2,012.9	92.1	76.9	3,265.1	92.7	62.2	4,728.2	90.5	44.8
2.1. Giro account and current account deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2.2. Savings deposits	0.0	0.0	0.0	0.1	0.0	13,000.0	0.1	0.0	-32.8
2.3. Time deposits	2,012.9	92.1	76.9	3,265.0	92.7	62.2	4,728.2	90.5	44.8
3. Other loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
3.1. Short-term loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
3.2. Long-term loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
4. Derivative financial liabilities and other financial liabilities held for trading	-	-	-	-	-	-	4.9	0.1	-
5. Debt securities issued	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
5.1. Short-term loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
5.2. Long-term loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
6. Subordinated instruments issued	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
7. Hybrid instruments issued	0.0	0.0	-100.0	10.7	0.3	0.0	10.7	0.2	0.3
8. Interest, fees and other liabilities	36.3	1.7	-2.4	89.4	2.5	146.2	324.1	6.2	262.5
Total liabilities	2,049.2	93.7	73.0	3,365.6	95.6	64.2	5,067.9	97.0	50.6
Total capital	137.1	6.3	20.0	154.8	4.4	12.9	155.6	3.0	0.5
Total liabilities and capital	2,186.3	100.0	68.3	3,520.4	100.0	61.0	5,223.5	100.0	48.4

Source: CNB.

3.7.2 Housing Savings Bank Capital

Total housing savings bank capital amounted to HRK 155.6m at the end of 2004, which is up by a mild 0.5% on a year earlier. The structure of housing savings

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

	2002			2003			2004		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Share capital	163.4	119.1	-5.6	193.4	124.9	18.4	203.4	130.7	5.2
2. Current year profit/loss	33.8	24.7	-325.5	-9.3	-6.0	-127.6	12.2	7.8	-
3. Retained earnings/loss	-73.2	-53.4	32.1	-51.5	-33.2	-29.7	-63.4	-40.8	23.3
4. Legal reserves	0.3	0.2	631.7	1.5	1.0	400.0	3.5	2.2	132.1
5. Total reserves provided for by the articles of association and other capital reserves	12.9	9.4	11.0	20.7	13.4	61.1	0.0	0.0	-100.0
5.1. Reserves provided for by the articles of association and other capital reserves	-	-	-	-	-	-	0.0	0.0	-
5.2. Unrealised gains/losses on value adjustment of financial assets available for sale	-	-	-	-	-	-	0.0	0.0	-
5.3. Reserves arising from hedging transactions	-	-	-	-	-	-	0.0	0.0	-
6. Previous year profit/loss	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total capital	137.1	100.0	20.0	154.8	100.0	12.9	155.6	100.0	0.5

Source: CNB.

bank capital reflects a rise in share capital and current year profit, but also in the share of retained loss. No housing savings bank reported reserves provided for by the articles of association and other capital reserves.

At the end of 2004, the capital adequacy ratio of housing savings banks stood at 27.6%, slightly down from 31.0% in 2003. Their regulatory capital totalled HRK 152.5m.

3.7.3 Asset Quality of Housing Savings Banks

Table 3.14 Classification of Housing Savings Bank Placements and Contingent Liabilities by Risk Groups
end of period, in million HRK and %

Placements	2002		2003		2004	
	Amount	Share	Amount	Share	Amount	Share
Fully recoverable placements	889.4	100.0	2,717.3	100.0	2,648.8	99.9
Partly recoverable placements	0.0	0.0	0.2	0.0	0.7	0.1
Irrecoverable placements	0.0	0.0	0.0	0.0	0.1	0.0
Total	889.4	100.0	2,717.5	100.0	2,649.6	100.0

Source: CNB.

At the end of 2004, fully recoverable placements and contingent liabilities made up 99.9% of total placements and contingent liabilities of housing savings banks, while partially recoverable placements and contingent liabilities accounted for the remaining 0.1%.

Table 3.15 Value Adjustment and Housing Savings Bank Provisions
end of period, in million HRK and %

	2002	2003	2004
Total value adjustment against placements and provisions for contingent liabilities	0.0	6.5	23.5
– value adjustment against placements	0.0	0.1	0.2
– provisions for unidentified losses	0.0	6.4	23.3
Total placements and contingent liabilities	889.4	2,717.5	2,649.6
Relative ratio of total value adjustment and provisions to total placements and contingent liabilities	0.0	0.2	0.9

Source: CNB.

Due to changes in regulations and a new system of recording business events in application as of the beginning of 2004, total placements and contingent liabilities of housing savings banks reported at the end of 2004 reduced by 2.5%. This resulted from the fact that housing savings banks entered investments in securities, which in accordance with previous regulations were regarded as placements, into books as portfolio of securities available for sale, which in accordance to new regulation are not reported as placements. However, despite the reduction in placements and contingent liabilities, loans to other clients, grew by 98.6%, thus increasing their share in the balance sheet structure from 5.3% to 7.1%.

The ratio of total value adjustment and provisions for contingent liabilities to total placements and contingent liabilities of housing savings banks stood at 0.9% at the end of 2004, which is a rise of 0.7 percentage points as compared to 2003. The relative ratio of total value adjustment and provisions to total placements and contingent liabilities of housing savings banks grew by 261.2% on 2003 as a result of the reduction in total placements paired with the rise in total value adjustments.

At the end of 2004, the share of provisions for unidentified losses in total value adjustment and provisions of housing savings banks made up 99.1%. Their amount increased by 265.2% over the period in question, reaching HRK 23.3m at the year end.

3.7.4 Housing Savings Banks Earnings Quality

In 2004, housing savings banks reported pre-tax profit of HRK 13.8m. Of four housing savings banks, three reported a profit in the total amount of HRK 19.1m, while one reported a loss of HRK 5.4m.

Net interest income of housing savings banks reduced by 0.8% at the end of 2004 as a consequence of larger relative growth of interest expenses, which rose by

Table 3.16 Housing Savings Bank Income Statement
in million HRK and %

	2002		2003		2004	
	Amount	Change	Amount	Change	Amount	Change
Total interest income	94.9	73.7	152.0	60.1	205.3	35.0
Total interest expenses	51.7	110.2	90.2	74.4	143.9	59.6
Net interest income	43.2	43.8	61.8	43.0	61.3	-0.8
Total income from commissions and fees	60.9	0.4	84.7	39.0	90.2	6.5
Total expenses on commissions and fees	20.7	16.1	21.5	3.8	7.6	-64.5
Net income from commissions and fees	40.2	-6.1	63.2	57.1	82.6	30.6
Other non-interest income	54.0	419.3	-3.1	-105.8	45.6	-
Other non-interest expenses	24.9	-39.8	29.4	17.8	40.7	38.6
Net other non-interest income	29.0	-	-32.5	-212.1	4.9	-
Net non-interest income	69.3	484.4	30.7	-55.7	87.5	184.9
General administrative expenses and depreciation	77.4	36.6	96.7	24.9	118.1	22.2
Net operating income before loss provisions	35.1	-	-4.2	-111.8	30.7	-
Expenses on value adjustment and provisions for identified losses	0.0	-185.7	0.1	-872.2	0.1	-35.3
Expenses on provisions for unidentified losses	1.3	499.1	4.8	269.3	16.9	255.0
Total expenses on loss provisions	1.3	438.1	4.9	285.5	17.0	246.8
Income/loss before taxes	33.8	-	-9.1	-126.8	13.8	-
Income tax	0.0	0.0	0.3	0.0	1.5	453.2
Current year profit/loss	33.8	-	-9.3	-127.6	12.2	-

Source: CNB.

59.6%, over interest income, which rose by 35.1%. However, net income from fees and commissions and net other non-interest income grew at substantial rates in 2004. Net income from fees and commissions rose as a result of the 6.5% rise in total income from fees and commissions paired with the 64.5% reduction of total expenses on fees and commissions.

Housing savings banks have been operating for seven consecutive years. Therefore, it is expected that they will register substantial income from interest on loans over the years to come since they will start granting a larger number of housing loans based on housing savings agreements with large contracted amounts, which require a minimum of 5 years of saving.

