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Banking Sector¹

1 All financial data for 2007 are based on the preliminary unaudited reports of banks and housing savings banks. In contrast, data for previous years are based on the audited reports of banks and housing savings banks.

3.1 Banks' Business Operations

The number of banks and housing saving banks operating in the Republic of Croatia remained unchanged in 2007 (Table 3.1). At the end of 2007, the share of banks' assets and the share of housing savings banks' assets in total banking sector assets stood at 98.1% and 1.9% respectively. Moreover, for a second consecutive year, banks showed a slight increase in their asset share, while an opposite trend in the asset share was reported by housing savings banks.

Table 3.1 Number of Banking Institutions

end of period

Banks	2005	2006	2007
Number of banks at the beginning of the year	37	34	33
Banks that merged with other banks	-2	-1	-
Banks undergoing winding-up proceedings	-1	-	-
Banks whose license was revoked	-	-	-
Number of banks at the end of the year	34	33	33
Housing savings banks			
Number of housing savings banks at the beginning of the year	4	4	5
Housing savings banks that were granted license	-	1	-
Number of housing savings banks (and savings banks) at the end of the year	4	5	5

Source: CNB.

The structure of bank peer groups² witnessed no changes in 2007. Including 23 banks, the group of small banks remained the largest peer group. The groups of medium-sized and large banks comprised 4 and 6 banks respectively (Table 3.2).

Table 3.2 Bank Peer Groups and Their Share in Total Bank Assets

end of period

	Number of banks			Share		
	2005	2006	2007	2005	2006	2007
Large banks	6	6	6	81.9	80.2	79.0
Medium-sized banks	4	4	4	10.4	12.0	12.8
Small banks	24	23	23	7.7	7.8	8.1
Total	34	33	33	100.0	100.0	100.0

Source: CNB.

² Depending on the size of the relative share of the bank's assets in the total assets of all banks at the end of the reporting period, banks have been divided into three peer groups: large, medium-sized and small banks. Large banks are banks whose assets exceed 5% of the total assets of all banks, medium-sized banks are banks whose assets are greater than 1% and less than 5% of the total assets of all banks, and small banks are banks whose assets are less than 1% of the total assets of all banks.

The asset share of large banks in total bank assets went down by more than 1 percentage point at the end of 2007 relative to the end of 2006 and accounted for, for the first time since 2004, less than four-fifths of total bank assets (79.0%). Consequently, the asset shares of medium-sized and small banks trended up by 0.8 percentage points and 0.3 percentage points respectively in 2007.

In addition, on the downward trend since the end of 2004, the asset share of the two largest banks decreased further to 41.0% at the end of 2007 relative to the end of 2006. The asset shares of the five largest banks and the ten largest banks displayed the same trends, falling to 71.5% and 91.9% respectively. Within this, the decrease in the asset share of the five largest banks was the greatest and stood at 1.1 percentage point.

For the first time since the end of 2002, the number of banks in foreign ownership prevailed over the number of banks in domestic private ownership. With one domestic private bank being acquired by the shareholders from San Marin, the number of banks in majority foreign ownership exceeded by one the number of banks in domestic private ownership (Figure 3.1). The number of banks in state ownership remained stagnant.

Notwithstanding these developments, the asset share of banks in majority foreign ownership in total bank assets went down at the end of 2007 relative to the end of 2006. Standing slightly below one-half of a percentage point, this decrease is attributed to the slower growth of assets in these banks (12.8%) as compared to the growth of banking system assets (13.4%). In addition, the asset share of banks in domestic private ownership fell by 0.1 percentage point or at a rate of 11.4%. In contrast, the asset share of banks in state ownership went up by 0.5 percentage points (Table 3.3), due to the growth rate in the state-owned banks' assets being two times higher than that in the banking system assets (26.1%).

3.1 Number of Banks by Ownership Residence and Form of Ownership

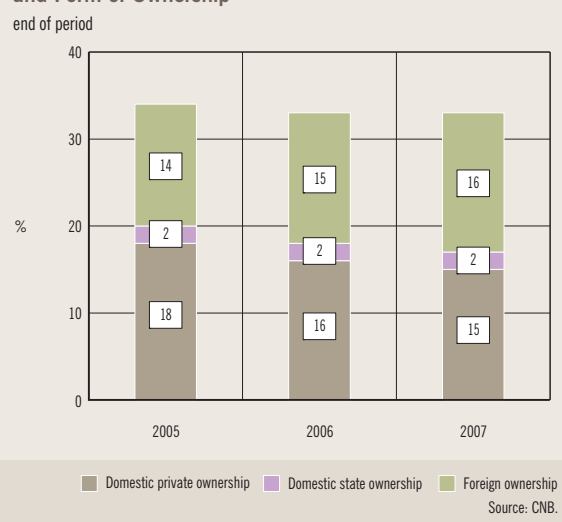


Table 3.3 Banks' Assets by Ownership Residence and Form of Ownership

in %

Banks by ownership residence and form of ownership	Bank peer groups' share of assets in total bank assets		
	2005	2006	2007
Banks in majority ownership of domestic shareholders	5.3	5.0	4.9
Banks in majority state ownership	3.4	4.2	4.7
Banks in majority ownership of foreign shareholders	91.3	90.8	90.4
Total	100.0	100.0	100.0

Source: CNB.

In terms of ownership, the most important change in 2007 was the transition of two banks from the majority Italian ownership into the majority Austrian ownership. As a result, the Austrian shareholders became the largest majority owners of banks operating in the Republic of Croatia, whereas in 2006 that position was held by the Italian shareholders. Specifically, the Austrian shareholders held seven banks, and the Italian shareholders held five banks. The remaining four banks in majority foreign ownership were held by the shareholders from France, Hungary, San Marin and Luxembourg. In addition, banks in majority Austrian ownership increased their asset share in total bank assets from 35.2% in 2006 to 59.1% in 2007, while the asset share of banks in majority Italian ownership fell from 43.6% to 20.1% (Figure 3.2).

The number of banking groups, on whose business operations the superordinate banks reported to the Croatian National Bank in line with the Decision on consolidated financial reports of a banking group,³ rose from eight to nine at end of 2007. The superordinate banks of these groups included Erste & Steiermärkische bank d.d., Hrvatska poštanska banka d.d., Hypo Alpe-Adria-Bank d.d., Karlovačka banka d.d., OTP banka Hrvatska d.d., Privredna banka Zagreb d.d., Raiffeisenbank Austria d.d., Slatinska banka d.d. and Zagrebačka banka d.d.

3.1.1 Banks' Balance Sheet

Structure of Banks' Assets

The total assets of banks amounted to HRK 345.0bn at the end of 2007, an increase of 13.3% over the end of 2006. Compared to the balance at the end of last year, 31 banks reported asset growth, while only two banks reported a decreased in their assets.

3.2 Banks' Assets by Shareholders' Domicile

end of period

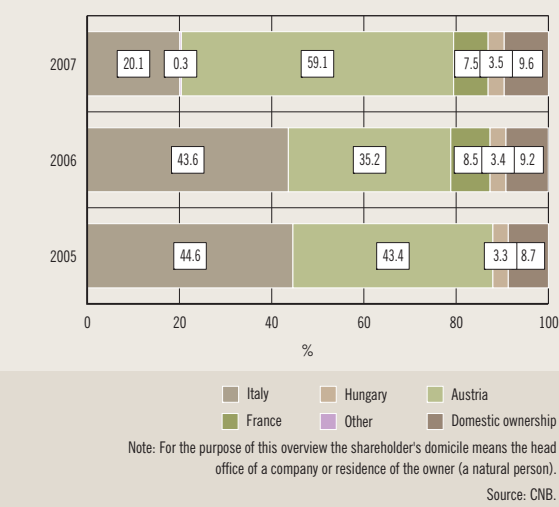


Table 3.4 Structure of Banks' Assets

end of period, in million HRK and %

	2005			2006			2007		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Money assets and deposits with the CNB	42,900.8	16.5	23.0	49,615.2	16.3	15.7	51,416.0	14.9	3.6
1.1. Money assets	3,347.1	1.3	9.3	3,931.0	1.3	17.4	4,551.9	1.3	15.8
1.2. Deposits with the CNB	39,553.7	15.2	24.3	45,684.2	15.0	15.5	46,864.2	13.6	2.6
2. Deposits with banking institutions	23,155.9	8.9	-30.6	26,005.6	8.5	12.3	35,118.0	10.2	35.0
3. MoF treasury bills and CNB bills	7,007.2	2.7	95.7	8,077.2	2.7	15.3	8,748.7	2.5	8.3
4. Securities and other financial instruments held for trading	8,285.5	3.2	26.2	7,730.4	2.5	-6.7	7,964.4	2.3	3.0
5. Securities and other financial instruments available for sale	11,820.8	4.5	19.2	12,678.2	4.2	7.3	11,318.3	3.3	-10.7
6. Securities and other financial instruments held to maturity	5,106.0	2.0	-22.1	3,311.9	1.1	-35.1	3,539.0	1.0	6.9
7. Securities and other financial instruments not traded in active markets but carried at fair value	1,101.4	0.4	-	460.1	0.2	-58.2	700.0	0.2	52.1
8. Derivative financial assets	147.3	0.1	-3.1	280.9	0.1	90.7	276.0	0.1	-1.8
9. Loans to financial institutions	3,867.3	1.5	17.6	4,035.4	1.3	4.3	7,099.5	2.1	75.9
10. Loans to other clients	148,092.5	56.9	21.5	183,740.0	60.3	24.1	209,327.9	60.7	13.9
11. Investments in subsidiaries, associates and joint ventures	1,595.7	0.6	-5.4	1,675.5	0.6	5.0	1,704.7	0.5	1.7
12. Foreclosed and repossessed assets	356.3	0.1	-0.5	445.6	0.1	25.1	357.4	0.1	-19.8
13. Tangible assets (net of depreciation)	4,198.8	1.6	10.9	4,434.1	1.5	5.6	4,509.0	1.3	1.7
14. Interest, fees and other assets	4,905.3	1.9	15.3	4,787.8	1.6	-2.4	5,786.1	1.7	20.9
15. Net of: Collectively assessed impairment provisions	2,263.1	0.9	13.4	2,672.6	0.9	18.1	2,866.8	0.8	7.3
Total assets	260,277.6	100.0	13.5	304,605.3	100.0	17.0	344,998.0	100.0	13.3

Note: The value of assets is expressed in gross amounts in Chapter 1.2.5 and in net amounts (i.e. net of impaired assets) in the above balance sheet.

Source: CNB.

The annual growth rate of banks' assets was lower at the end of 2007 than at the end of 2006 (17.0%) and the end of 2005 (13.5%). The observed slowdown may to a large extent be attributed to the measure on the compulsory

³ OG 17/2003 and 149/2005.

purchase of CNB bills. Specifically, in the first six months of 2007, the banks' assets grew at a rate of 6.8%. However, with a further tightening of the measure, they slowed down to 6.1% in the second half of the year. Shown on a quarterly basis, the growth rate of banks' assets was the lowest in the last quarter of 2007 (1.5%), which was not in line with usual movements in balance sheets at business year end.

For a third year in a row, medium-sized banks reported the strongest growth in their assets, up 20.8% at the end of 2007 relative to the end of 2006. The asset growth of small banks amounted to 18.9%, while the lowest asset growth rate was reported by large banks (11.6%).

The most significant change in banks' balance sheets in 2007 was the currency restructuring of their assets and liabilities, i.e. the increase in their kuna denominated items. At the end of 2007, compared to the end of 2006, the assets denominated in kuna went up by HRK 39.9bn or 37.4%, lagging slightly behind the overall asset growth in 2007. In addition, the assets denominated in kuna and indexed to foreign currency fell by HRK 1.7bn or 1.4% over the same period. The major contributors to this were the increase in the kuna denominated share of assets in total assets from 35.0% in 2006 to 42.5 in 2007 and the decrease in the share of foreign currency indexed kuna assets in total assets from 39.4% to 34.3%. Liabilities showed an even more pronounced change in their currency structure, with kuna denominated items increasing by HRK 47.0bn (38.6%) and items denominated in kuna and indexed to foreign currency decreasing by HRK 15.0bn (45.5%). Hence, the share of kuna denominated items in total liabilities went up from 39.9% to 48.9%, and the share of foreign currency indexed items fell from 10.8% to 5.2%.

The growth in total loans extended (HRK 28.6bn or 15.3%) was the main driving force behind the overall growth in assets at the end of 2007 relative to the end of 2006. In addition to loans extended to financial institutions, which grew by 75.9% and thus exceeded the overall growth in assets, the year 2007 was also marked by the increase in loans to other clients (13.9%). Together, they contributed more than 1 percentage point to the growth in the share of loans in total bank assets. Moreover, all bank peer groups saw an increase in their shares of loans in assets, amounting to 1 percentage point in large and medium-sized banks and 2 percentage points in small banks. After reporting an increase of 13.4%, large banks had the largest share of loans extended in their assets (63.2%) at the end of 2007 relative to the end of 2006. Medium-sized banks reported an increase of 22.8%, with loans extended accounting for 61.1% of their assets. Finally, after growing by 23.0%, the share of loans extended in the assets of small banks stood at 61.0%.

Deposits with other banks were 35.0% higher at the end of 2007 than at the end of 2006. The second half of 2007 was marked by a considerable increase in total deposits, due mostly to the growth in time deposits and deposits with notice period with foreign banks. This change is attributed to a concurrent increase in foreign currency liabilities of banks. Specifically, in line with the Decision on the minimum required amount of foreign currency claims, banks were required to maintain a 32% coverage ratio between their foreign currency liabilities and foreign currency assets. Money assets and deposits with the CNB rose by 2.6% at the end of 2007 over the end of 2006, while the largest increase within the item of total deposits with the CNB was seen in reserve requirement deposits (7.4%).

Banks' investment in securities, T-bills included, totalled HRK 32.3bn at the end of 2007, with the total amount invested stagnating at its end-2006 level. Investment in debt securities fell by 2.2%, reaching 96.3% at year-end. Concurrently, investment in equity securities, accounting for 3.7% of the total, rose by 135.0%. Broken down by the type of instrument, more than a half of total investment was made in bonds (51.9%), while investment in T-bills accounted for the second largest share of 27.1%.

The household sector was in focus of bank lending activities in 2007. Specifically, 50.6% or more than a half of total net loans was extended to this particular sector. Loans to households reached HRK 109.5bn at the end of 2007, an increase of HRK 16.9bn (18.2%) over

3.3 Structure of Bank Peer Groups' Assets



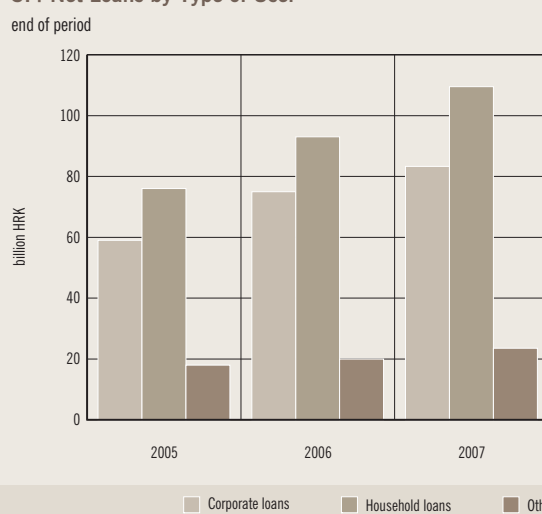
the end of 2006. Accounting for less than a half of that increase, home loans grew by 22.5% in the reference period, while their share in total net loans extended to households and total net loans of banks stood at 41.0% and 20.7% respectively. Other loans extended to households also grew at a high rate (17.6%), in part due to an increase in loans for the purchase of shares of some state-owned enterprises in the second half of 2007.

Loans extended in kuna, up by HRK 15.4bn, made up more than 90% of the total increase in household loans in 2007. Consequently, this changed the currency structure of loans extended to households, with loans indexed to foreign currency decreasing from 78.0% to 67.4% and loans denominated in kuna increasing from 21.7% to 32.4% at the end of 2006 relative to the end of 2007.

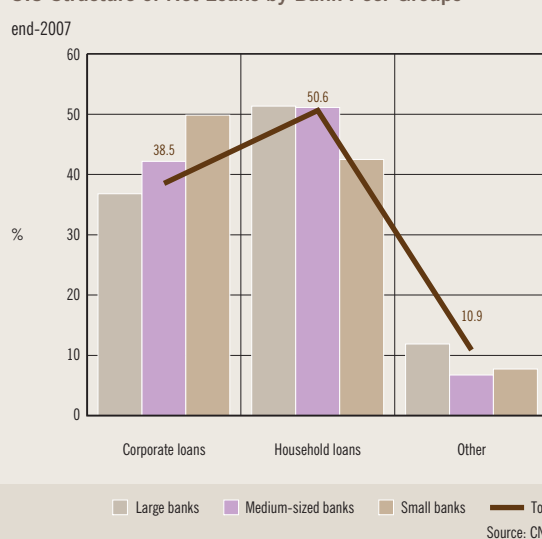
Loans to enterprises rose by HRK 8.3bn or 11.0% in 2007. Growing slower than total net loans of banks, the share of loans to enterprises in total net loans dipped from 40.0% at the end of 2006 to 38.5% at the end of 2007. Loans to other sectors went up by 17.6% in the reference period, due mostly to an increase in loans to financial institutions (75.9%).

Loans extended in foreign currency or indexed to foreign currency accounted for 61.4% of total net loans at the end of 2007, a decrease of over 10 percentage points from the end of 2006. As much as 70.9% of net loans extended in foreign currency or indexed to foreign currency were linked to euro. After declining by 6.5% at the end of 2007, these loans decreased their share in the currency structure of net loans by 4 percentage points. Concurrently, loans indexed to Swiss francs went up by 26.2%, increasing their share in total net loans from 21.0% at the end of 2006 to 26.8% at the end of 2007.

3.4 Net Loans by Type of User



3.5 Structure of Net Loans by Bank Peer Groups



Structure of Banks' Liabilities

Banks raised HRK 30.2bn in deposits in 2007, 14.9% more than at the end of 2006. As a result, deposits accounted for almost three-fourths of the overall growth in banks' liabilities. With deposits growing faster than total bank liabilities, the share of deposits in total bank liabilities went up by 1 percentage point at the end of 2007 relative to the end of 2006, reaching a total of 67.6%. Loans received were the second major source of bank financing, accounting for 15.0% of total bank liabilities at the end of 2007. However, as loans received fell by 5.4% at the end of 2007 over the end of 2006, their share in total liabilities fell by almost 3 percentage points. The share of capital in total bank liabilities grew by 2.3 percentage points (12.5%) at the end of 2007 relative to the end of 2006, thus continuing a years-long upward trend.

Deposits made up the largest share in the liabilities of small banks (74.0%) and the smallest in the liabilities of large banks (66.3%). Deposits of medium-sized banks accounted for 71.1% of their liabilities, growing at the highest annual rate in the reference period (20.3%). In 2007, the annual growth rate of deposits of small and medium-sized banks stood at 16.5% and 13.8% respectively.

Table 3.5 Structure of Banks' Liabilities

end of period, in million HRK and %

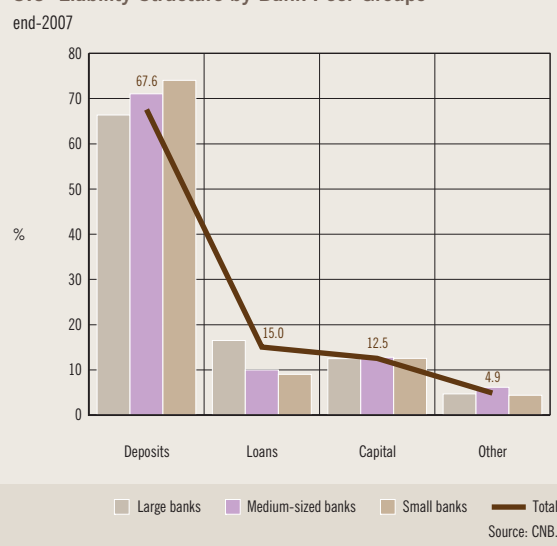
	2005			2006			2007		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Loans from financial institutions	13,844.2	5.3	63.6	15,102.5	5.0	9.1	20,338.6	5.9	34.7
1.1. Short-term loans	7,346.5	2.8	104.5	7,286.7	2.4	-0.8	11,091.6	3.2	52.2
1.2. Long-term loans	6,497.7	2.5	33.4	7,815.8	2.6	20.3	9,247.0	2.7	18.3
2. Deposits	171,742.0	66.0	10.6	202,950.5	66.6	18.2	233,122.1	67.6	14.9
2.1. Giro account and current account deposits	29,175.2	11.2	14.1	37,696.5	12.4	29.2	45,283.6	13.1	20.1
2.2. Savings deposits	26,124.5	10.0	3.6	26,601.4	8.7	1.8	26,874.1	7.8	1.0
2.3. Time deposits	116,442.2	44.7	11.4	138,652.5	45.5	19.1	160,964.3	46.7	16.1
3. Other loans	36,191.2	13.9	15.4	39,762.9	13.1	9.9	31,549.5	9.1	-20.7
3.1. Short-term loans	8,213.9	3.2	56.0	10,028.1	3.3	22.1	5,339.4	1.5	-46.8
3.2. Long-term loans	27,977.3	10.7	7.2	29,734.8	9.8	6.3	26,210.1	7.6	-11.9
4. Derivative financial liabilities and other financial liabilities held for trading	223.7	0.1	-6.3	221.6	0.1	-0.9	367.5	0.1	65.9
5. Debt securities issued	3,396.9	1.3	-3.9	3,583.4	1.2	5.5	3,476.7	1.0	-3.0
5.1. Short-term debt securities issued	0.0	0.0	-	0.0	0.0	-	0.0	0.0	-
5.2. Long-term debt securities issued	3,396.9	1.3	-3.9	3,583.4	1.2	5.5	3,476.7	1.0	-3.0
6. Subordinated instruments issued	770.7	0.3	-5.8	758.1	0.2	-1.6	225.7	0.1	-70.2
7. Hybrid instruments issued	886.6	0.3	-46.0	552.4	0.2	-37.7	636.6	0.2	15.2
8. Interest, fees and other liabilities	9,778.8	3.8	18.1	10,413.5	3.4	6.5	12,057.7	3.5	15.8
Total liabilities	236,834.2	91.0	13.0	273,344.9	89.7	15.4	301,774.4	87.5	10.4
Total capital	23,443.5	9.0	19.1	31,260.3	10.3	33.3	43,223.6	12.5	38.3
Total liabilities and capital	260,277.6	100.0	13.5	304,605.3	100.0	17.0	344,998.0	100.0	13.3

Note: The value of assets is expressed in gross amounts in Chapter 1.2.5 and in net amounts (i.e. net of impaired assets) in the above balance sheet.
Source: CNB.

Received loans of individual bank peer groups displayed a trend opposite to that observed for deposits. Hence, at the end of 2007, received loans dominated in the liabilities of large banks (16.5%), and accounted for 10.0% and 9.0% respectively in the liabilities of medium-sized and small banks.

Larger at the end of 2007 than at the end of 2006, household deposits and corporate deposits contributed most to the overall increase in received deposits. Although increasing by HRK 11.5bn in the reference period and thus recording the largest change in nominal terms, the growth rate of household deposits (10.4%) was lower than that for other institutional sectors. The exception to this were non-resident deposits which trended downward in 2007. As a result, the share of household deposits in total deposits fell from 54.4% at the end of 2006 to 52.2% at the end of 2007. In nominal terms, the second largest change occurred in corporate deposits, which, after growing by HRK 11.2bn (26.3%) in the reference period, increased their share in total deposits from 21.0% at the end of 2006 to 23.1% at the end of 2007. Deposits of financial institutions showed the largest annual rate of growth (70.2%), rising by a total of HRK 8.0bn. Deposits of non-residents fell by HRK 2.0bn (6.2%) in 2007. As one of the major categories in total non-resident deposits, deposits received from majority foreign owners showed the same trend at the end of 2007, accounting for 9.5% of total deposits.

3.6 Liability Structure by Bank Peer Groups

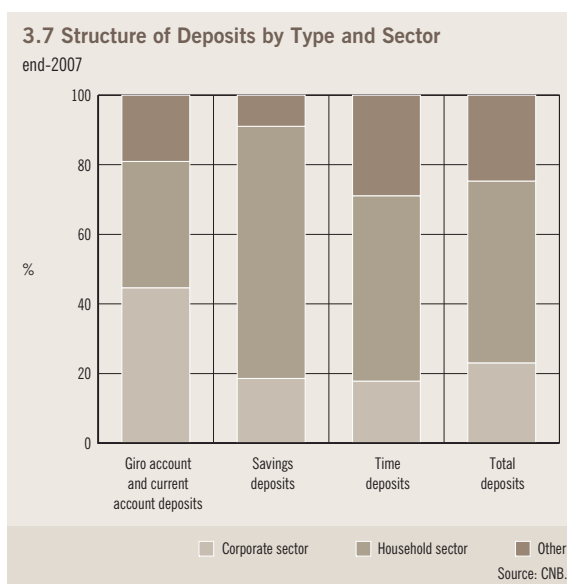


The maturity structure of received deposits saw a modest change at the end of 2007 relative to the end of 2006. The share of savings deposits in total deposits changed most in 2007, and, after declining by 1.6 percentage points, it

accounted for 11.5% of total deposits. The share of giro and current account deposits in total deposits stood 19.4% at the end of 2007, with time deposits making up the largest share of total deposits (69.1%) in the reference period. The observed decline in the share of saving deposits is attributed to their low annual rate of growth of only 1.0%. In contrast, deposits in giro and current accounts rose at the highest annual rate (20.1%), and time deposits went up by 16.1%.

In terms of currency structure, at the end of 2007, relative to the end of 2006, some more significant changes were seen in the shares of kuna deposits and deposits indexed to foreign currency. After growing at a rate of 39.0% and increasing by HRK 28.0bn in nominal terms, the share of kuna deposits in total deposits rose from 35.4% at the end of 2006 to 42.9% at the end of 2007. Concurrently, deposits indexed to foreign currency declined by HRK 11.2bn or 50.5%, and their share in total deposits went down from 10.9% at the end of 2006 to 4.7% at the end of 2007. Foreign currency deposits increased by 12.2%, continuing to account for the largest share in total deposits (52.5%).

Notwithstanding a 20.6% decrease in loans received from non-residents, the share of banks' liabilities owed to non-residents was also the largest in 2007 (60.5%). Specifically, more than a half of loans received from non-residents and 33.7% of total received loans in 2007 were the loans received from majority foreign owners, while liabilities on these loans went down by 23.6% at the end of 2007 relative to the end of 2006. At the peer group level, the group of small banks was the only group to utilise these loans in a larger amount in 2007 relative to 2006.



3.1.2 Banks' Capital

The total capital of banks amounted to HRK 43.2bn at the end of 2007, a rise of 38.3% over the end of 2006. The major contributor to this was the increase in share capital, up HRK 8.6bn or 51.8% over the end of 2006, generated by the recapitalisation of three large and three medium-sized banks and six small banks. As a result, the share of share capital in total capital of banks went up from 53.1% at the end of 2006 to 58.3% at the end of 2007. In addition, banks distributed the profit earned in 2006 mostly into capital, increasing thus in 2007 their retained earnings and reserves, and reported the increase in their current year profit of 21.5%.

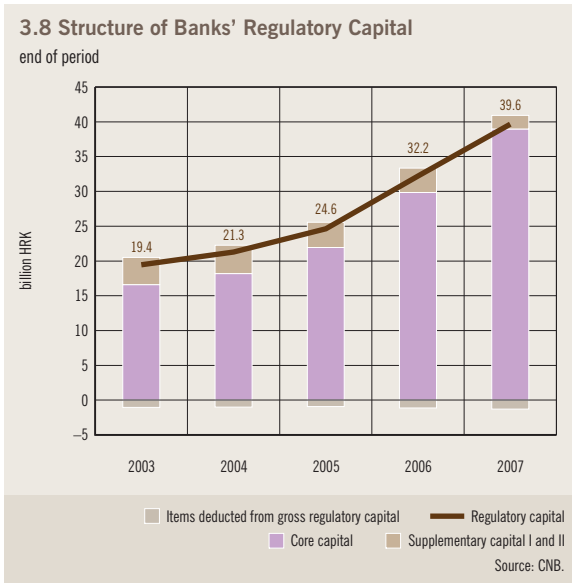
Table 3.6 Structure of Banks' Total Capital

end of period, in million HRK and %

	2005			2006			2007		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Share capital	11,523.3	49.2	13.9	16,584.2	53.1	43.9	25,179.3	58.3	51.8
2. Current year profit/loss	3,247.8	13.9	6.9	3,394.8	10.9	4.5	4,123.7	9.5	21.5
3. Retained earnings/loss	2,499.9	10.7	31.6	3,716.8	11.9	48.7	4,202.6	9.7	13.1
4. Legal reserves	798.4	3.4	11.2	882.4	2.8	10.5	1,054.3	2.4	19.5
5. Total reserves provided for by the articles of association and other capital reserves	5,350.4	22.8	36.6	6,662.0	21.3	24.5	8,647.3	20.0	29.8
6. Unrealised gains/losses on value adjustments of financial assets available for sale	23.5	0.1	–	14.6	0.0	–37.8	30.7	0.1	109.5
7. Reserves arising from hedging transactions	0.0	0.0	–	8.3	0.0	–	–0.8	0.0	–109.4
8. Previous year profit/loss	0.2	0.0	–	–2.7	0.0	–1,300.9	–13.6	0.0	396.3
Total capital	23,443.5	100.0	19.1	31,260.3	100.0	33.3	43,223.6	100.0	38.3

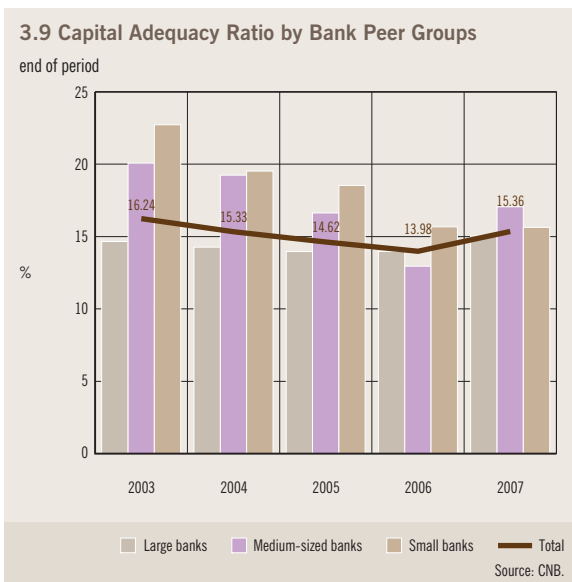
Source: CNB.

After increasing by 23.0% in 2007, the regulatory capital of banks reached a total of HRK 39.6bn. This growth was to a large extent the result of bank recapitalisations in 2007, i.e. a 30.4% increase in their core capital. Following the conversion of some subordinated instruments into share capital and the resultant modest decrease in gross supplementary capital I, the share of supplementary capital I in regulatory capital went down by 44.1% at the end of 2007 relative to the end of 2006. The increase in items deducted from gross supplementary capital I (HRK 1.5bn), which is almost entirely ascribed to the exclusion of a portion of collectively assessed impairment provisions from regulatory capital, was the main contributor to the observed decrease.⁴ Two small banks reported a negligible amount of supplementary capital II at the end of 2007. The strong growth in core capital and the concurrent decrease in supplementary capital I triggered a change in the structure of banks' regulatory capital, with the share of core capital increasing from 89.5% at the end of 2006 to 95.2% at the end of 2007.



The regulatory capital amount for 2007 was calculated on the basis of unaudited preliminary data and it did not include the current year profit. The decision on the inclusion of the current year profit in the regulatory capital for 2007 will be adopted by banks after the audit of their operations is carried out and after the final financial results for 2007 are obtained. As a result, the annual growth rate of regulatory capital is expected to exceed the stated 23.0%.

After trending downward for several years, the capital adequacy ratio rose to 15.36% in 2007 (Figure 3.9). The registered increase in the capital adequacy ratio (in 2006, it stood at 13.98%) was in part the result of monetary policy measures aimed at slowing down the growth of bank placements, prompting banks to increasingly use their capital as a source of growth. As a result, at the end of last year, the growth rate of regulatory capital was almost two times higher (23.0%) than the growth rate of total bank exposures to credit and market risks (12.0%).



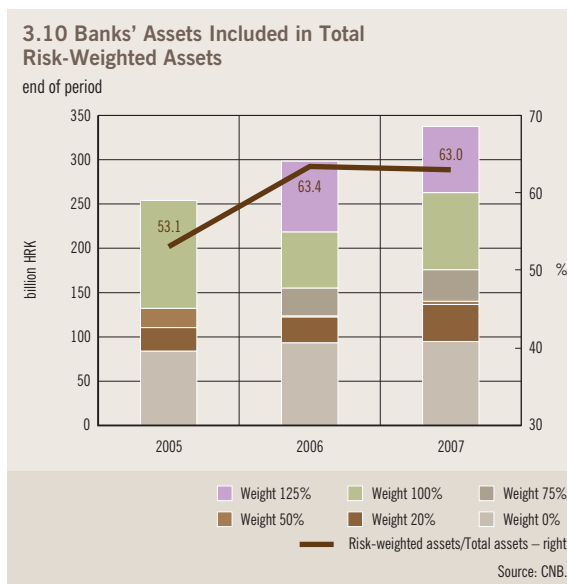
The group of medium-sized banks reported the highest capital adequacy ratio (17.06%) and the highest growth rate of the ratio (4.1 percentage points) at the end of 2007 relative to end of 2006. Although declining negligibly at the end of 2007 relative to the end of 2006, the capital adequacy ratio of small banks stood at 15.63%. After reaching 15.04% in 2007, the capital adequacy ratio of large banks went up by 1.1 percentage points. None of the banks reported the capital adequacy ratio lower than the regulatory prescribed minimum of 10%, while seven bank with the asset share of 20.9% in total bank assets reported the capital adequacy ratio smaller than 11%.

The risk-weighted assets grew by 13.2% in net terms at the end of 2007 relative to the end of 2006. More

⁴ The obligation to exclude the collectively assessed impairment provisions from the regulatory capital was set forth by the amendments to the Instruction for the uniform implementation of the decision on the capital adequacy of banks (OG 41/2006). Accordingly, banks undertook to gradually exclude the collectively assessed impairment provisions from their supplementary capital I as of 30 June 2006, and are expected to complete this process by the end of 2008. Hence, their reports relating to 31 December 2008 will not contain a reference to collectively assessed impairment provisions. By contrast, if their collectively assessed impairment provisions exceeded 0.50% of the sum of total credit-risk weighted balance sheet assets, total credit-risk weighted off-balance sheet items and total of other off-balance sheet items weighted by credit risk, banks were required to report these provisions as an item deducted from supplementary capital I in their reports relating to 31 December 2007.

than one half of that increase was accounted for by the rise in kuna claims that are not covered by deposits or other pledged assets and that are assigned a risk weight of 100% (Figure 3.10). The currency restructuring of banks' assets contributed to a decline in claims that are most exposed to currency induced credit risk (weighted by a 125% risk weight). As a result, the inadequately insured foreign currency claims and the foreign currency indexed claims on borrowers with unmatched foreign exchange positions fell by 6.5% at the end of 2007 relative to the end of 2006. In addition, the slower growth in risk-weighted assets than in total assets caused a mild decrease in their ratio, from 63.4% at the end of 2006 to 63.0% at the end of 2007.

Total capital requirements showed only a mild change in the reference period. Specifically, the capital requirement for market risk rose by 26.8%, pushing up its share in total capital requirements from 2.8% at the end of 2006 to 3.2% at the end of 2007. Concurrently, the capital requirement for credit risk rose by 11.6%, due mostly to the increase in risk-weighted assets by 12.5%.



3.1.3 Quality of Banks' Assets

Total placements and contingent liabilities of banks increased by 13.5% or HRK 47.3bn, or at a rate that was by almost one half lower than that seen in 2006 (25.5%). Of HRK 396.9bn thus obtained, HRK 328.0bn or 82.6% went to placements (up 13.7% annually) and HRK 68.9bn or 17.4% to contingent liabilities (up 12.5% annually). The main contributor to this was the increase in gross loans and deposits, which accounted for more than three-fourths of total placements and contingent liabilities at the end of 2007 (loans and deposits stood at 56.0% and 20.6% respectively). After growing at a rate of 14.9% (HRK 28.7bn), gross loans participated with 60.8% in the total growth of all placements and contingent liabilities. In addition, after increasing by 15.1%, deposits reached a total of HRK 10.7bn in the reference period. Hence, loans and deposits, as the two single largest components of total placement, increased their shares by an additional 0.65 percentage points and 0.28 percentage points respectively in 2007, while the share of contingent liabilities trended downward by 0.2 percentage points.

The quality of placements and contingent liabilities improved slightly in 2007. The share of fully recoverable placements (category A) rose thus by 0.1 percentage point, while the share of irrecoverable placements (category C) decreased by the same percentage. Moreover, the share of partly recoverable placements and contingent liabilities remained at the level attained at the end of 2006 (Table 3.7).

Table 3.7 Classification of Banks' Placements and Contingent Liabilities by Risk Categories

end of period, in million HRK and %

Placements	2005		2006		2007	
	Amount	Share	Amount	Share	Amount	Share
Fully recoverable placements (category A)	267,835.4	96.0	338,327.5	96.8	384,742.9	96.9
Partly recoverable placements (category B)	6,801.6	2.4	7,129.1	2.0	7,879.4	2.0
Irrecoverable placements (category C)	4,238.5	1.5	4,173.1	1.2	4,265.4	1.1
Total	278,875.5	100.0	349,629.8	100.0	396,887.7	100.0

Source: CNB.

The observed shifts in the quality of placements are attributed to substantially faster growth in the category A placements (13.7% or HRK 46.4bn) than in the category B and category C placements (7.5% or HRK 842.5m). Within the latter, the category B placements went up by 10.5% and the category C placements by 2.2%. Although 1.8 percentage points lower at the end of 2007 than at the end of 2006, non-performing loans accounted for almost nine-tenths of non-performing placements (87.6%). The registered decrease in non-performing loans is attributed

to their slower growth as compared to the growth in total non-performing placements (5.3% vs. 7.5%). Debt securities and other available-for-sale assets were the fastest growing items within the categories B and C (97.8%), keeping their share in total non-performing placements and contingent liabilities below one percent (0.7%). The second fastest growing items within the categories B and C were the contingent liabilities that trended up by 41.7% and held a share of 8.6%.

The ratio of total value adjustments and provisions to total placements and contingent liabilities narrowed by an additional 0.1 percentage point in 2007 on the back of faster growth in total placements and contingent liabilities. The value adjustments and provisions rose by 5.7% in the reference period (within this, the value adjustments against placements and provisions for contingent liabilities went up by 1.5% and the collectively assessed impairment provisions by 14.2%). Moreover, the stated growth in total placements and contingent liabilities (13.5%) was more than two times higher at the end of 2007 than at the end of 2006 (Table 3.8).

Table 3.8 Banks' Value Adjustments and Provisions

end of period, in million HRK and %

	2005	2006	2007
Total value adjustments against placements and provisions for contingent liabilities	9,002.3	9,246.9	9,774.9
– Value adjustments against placements and provisions for contingent liabilities	6,427.8	6,195.9	6,290.0
– Collectively assessed impairment provisions	2,574.5	3,051.0	3,484.9
Total placements and contingent liabilities	272,447.7	349,629.8	396,887.7
Relative ratio: total value adjustments and provisions/total placements and contingent liabilities	3.3	2.6	2.5

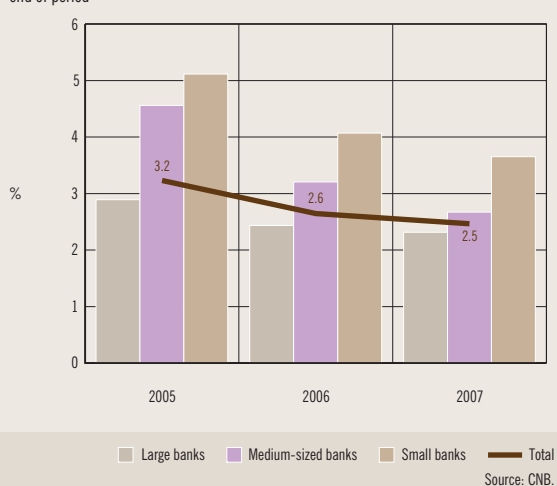
Source: CNB.

The coverage of total placements and contingent liabilities with total value adjustments and provisions, although decreasing annually, remained the highest in the group of small banks (3.7%). With the same downward trend observed in the other two groups of banks, the coverage ratio reached 2.7% in the group of medium-sized banks and 2.4% in the group of large banks, which, at the same time, has the largest influence on the system as a whole.

The exposure of net placements to currency induced credit risk (CICR), the monitoring of which began in mid-2006, narrowed considerably at the end of 2007, with the share of placements exposed to CICR in total net placements declining from 61.0% at the end of 2006 to 54.3% at the end of 2007. In 2007, placements exposed to CICR rose by HRK 2.5bn (1.2%) or at a considerably lower rate than total net placements and contingent liabilities (13.7% or HRK 47.2bn). The share of hedged placements in total net placements also increased in 2007 relative to 2006, from 23.4% to 24.5%.

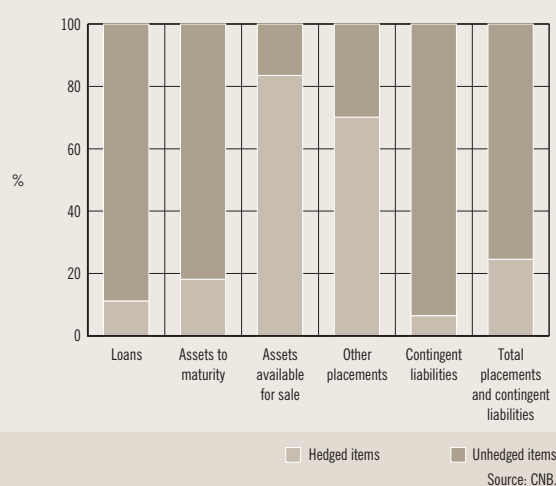
3.11 Ratio of Placements and Contingent Liabilities to Value Adjustment and Provisions by Bank Peer Groups

end of period



3.12 Structure of Net Placements Exposed to CICR

end-2007



Broken down by the type of placement, contingent liabilities were the least hedged items in the reference period, as well as the only items to see a decrease in their degree of hedge effectiveness (the hedged portion of these liabilities stood at 10.2% at the end of 2006, while it amounted to 6.5% at the end of 2007). The share of hedged loans in total loan exposures rose from 9.8% at the end of 2006 to 11.2% at the end of 2007 (Figure 3.12).

At the end of 2007, like at the end of 2006, non-residents and financial institutions were the most hedged sectors (their share of hedged items in total placements exposed to CICR was higher than 70.0%). By contrast, the hedged items of other sectors did not exceed 10.0%. The household sector became the least hedged sector (the position that was previously held by the sector of non-profit institutions), while its share of hedged placements in total placements exposed to CICR amounted to 4.9%.

The insured amount of total net placements of banks decreased by 1.9 percentage points at the end of 2007, with the share of placements covered by quality insurance instruments amounting to 40.2%. The estimated value of quality insurance instruments accounted for 87.6% of the value of total net placements insured by these instruments. Property insurance accounted for the lion's share of total net placements. Residential and business property accounted for 35.4% and 22.5% respectively, while the remaining portion of net placements was covered by other quality insurance instruments.

3.1.4 Quality of Banks' Earnings

Banks reported positive operating financial results for 2007, with a number of sources contributing to an exceptionally high growth of income. Higher lending volume, despite narrower margins, caused a rise in interest income, while positive developments in the financial market resulted in gains on trading book positions. The penetration of new services, especially other banking services⁵ (investment and card services, e-banking, etc.), into the market was the key factor contributing to high growth of income from fees and commissions. The cost efficiency, measured as a ratio between general expenses and net income, continued to trend upward. Notwithstanding the exchange rate translation differences, higher expenses on loss provisions were the only item to contribute negatively to final operating results of banks.

In 2007, banks reported HRK 5.1bn in income before taxes (Table 3.9). Compared with the end of 2006, income before taxes grew by 21.3% or to its record high since 2002.⁶ Banks reported the increase in income before taxes of 5.1% and 10.9% in 2005 and 2004 respectively, while the growth rate of their income before taxes in 2004 resembled that seen in 2007 (20.7%).

Of 53 banks operating in the system, 30 banks achieved a total income before taxes to the amount of HRK 5,168m, while only three banks declared a loss of HRK 31m. The share of assets of these banks in total bank assets on the date of the report was 0.6%.

At the peer group level, income before taxes of medium-sized banks grew at the highest rate (31.6%) in 2007, while that of small banks grew at the lowest rate (3.7%). In addition, large banks increased their income before taxes by 21.6% and their share in total income of all banks amounted to 84.4%. Medium-sized and small banks had relatively small shares of income, which, standing at 9.3% and 6.3% respectively, were lower than their asset shares in total bank assets.

⁵ The acceptance of deposits and the extension of loans from these sources of funds are viewed exclusively as banking services. If duly authorised, other business entities may, in addition to banks, provide other banking services.

⁶ The high income before taxes in 2002 (107.1%) is attributed to the low level of income earned in 2001, i.e. to trading losses in Riječka banka.

Table 3.9 Banks' Income Statement

in million HRK and %

	2005		2006		2007	
	Amount	Change	Amount	Change	Amount	Change
Total interest income	12,915.2	9.4	14,887.9	15.3	18,245.9	22.6
Total interest expenses	5,910.0	10.2	7,197.2	21.8	9,691.5	34.7
Net interest income	7,005.2	8.8	7,690.7	9.8	8,554.4	11.2
Total income from fees and commissions	3,323.1	7.8	3,598.1	8.3	4,207.5	16.9
Total expenses on fees and commissions	1,385.0	-3.7	1,374.3	-0.8	1,368.4	-0.4
Net income from fees and commissions	1,938.1	17.8	2,223.8	14.7	2,839.1	27.7
Other non-interest income	1,760.9	-4.6	1,897.8	7.8	2,092.3	10.2
Other non-interest expenses	719.0	16.2	899.3	25.1	802.5	-10.8
Net other non-interest income	1,041.9	-15.1	998.5	-4.2	1,289.8	29.2
Net non-interest income	2,980.0	3.8	3,222.2	8.1	4,128.9	28.1
General administrative expenses and depreciation	5,430.1	7.4	5,996.1	10.4	6,608.2	10.2
Net operating income before loss provisions	4,555.1	7.1	4,916.8	7.9	6,075.1	23.6
Expenses on value adjustments and provisions for identified losses	186.3	-53.7	203.9	9.4	503.5	146.9
Expenses on collectively assessed impairment provisions	338.6	56.6	476.6	40.7	434.1	-8.9
Total expenses on loss provisions	524.9	-15.1	680.5	29.6	937.5	37.8
Income/loss before taxes	4,030.2	10.9	4,236.3	5.1	5,137.6	21.3
Income tax	782.4	31.0	841.5	7.6	1,013.9	20.5
Current year profit/loss	3,247.8	6.9	3,394.8	4.5	4,123.7	21.5

Source: CNB.

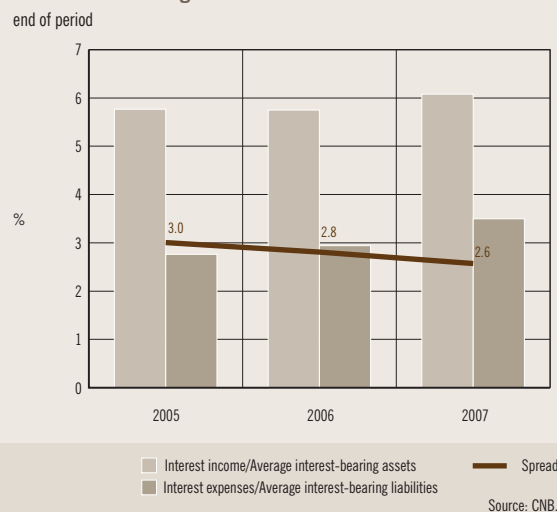
Net income of banks (calculated as a sum of net interest and net non-interest income) rose by 16.2% in 2007, with the increase in general operating expenses and expenses on loss provisions standing at 10.2% and 37.8% respectively.

More than a half of the overall increase in net income of banks is attributed to the increase in net non-interest income, i.e. to the increase in one-off and less stable sources of income. The major contributor to this was the growth in net income from fees and commission of 27.7%. Income from fees for payment operations services grew by a modest 4.7%, with the increase in total net income from fees and commissions being ascribed to a 30.0% growth in income from fees and commissions for other banking services (investment and card services, e-banking, deposit account services, etc.).

An exceptionally good year in the financial market contributed to the increase in income from trading activities (38.5%), with the growth in net other non-interest income standing at 29.2%. The growth rate of net other non-interest income would have been even more pronounced if banks had not incurred the losses from exchange rate translation differences and reported the decrease in income from available-for-sale assets (80.2%). The decrease in income earned on the available-for-sale portfolio was above all the result of unfavourable developments in debt securities prices in the domestic market in 2007.

Net interest income, as the main and most stable source of banks' income, rose by 11.2% at the end of 2007 relative to the end of 2006. Specifically, notwithstanding the limitation on the permissible growth of placements and contingent liabilities (i.e. the measure triggering the purchase of compulsory CNB bills) and a sizeable increase in net interest income in the reference period, the share of net interest income in net income fell from 70.5% to 67.5%. Moreover, this share fell in all groups of banks, posting the lowest growth rate in the group of

3.13 Income from Interest-Bearing Assets and Expenses on Interest-Bearing Liabilities



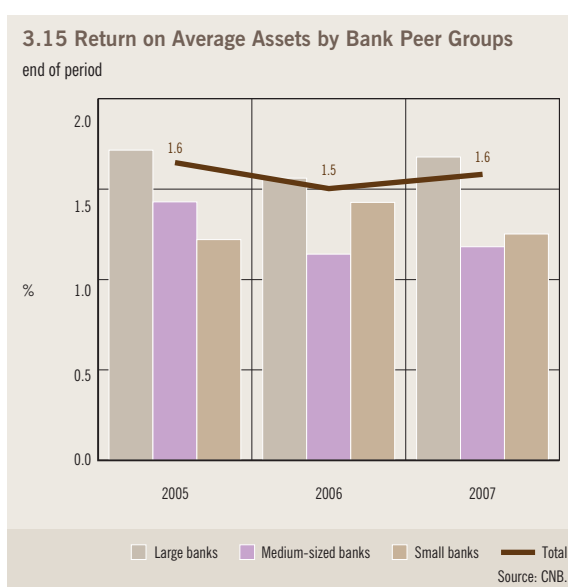
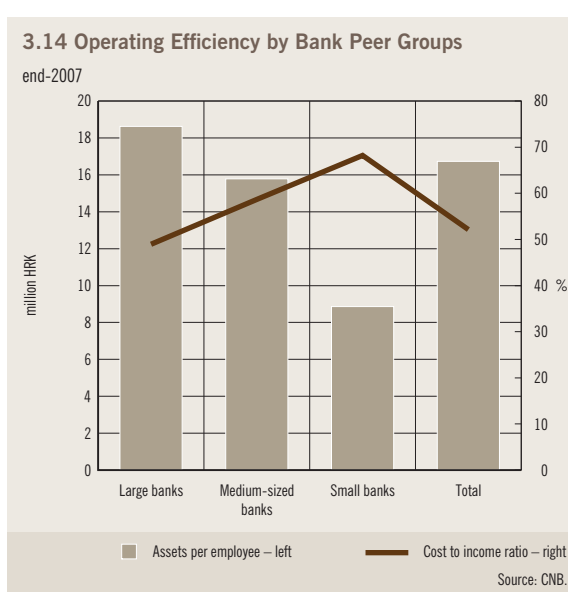
large banks (66.1%). By contrast, owing to their reliance on more traditional banking services, medium-sized and small banks posted higher growth rates of net interest income of 73.1% and 70.7% respectively. Owing to faster growth of net other non-interest income from foreign currency purchase/sale transactions in small banks than in medium-sized banks (12.7% vs. 5.7%), medium-sized banks reported higher share of net interest income than small banks.

Faster growth in interest expenses than in interest income resulted in the widening of their ratio from 48.3% at the end of 2006 to 53.1% at the end of 2007. Larger interest expenses were above all the result of the increase in interest rates on deposits and the growth in deposits. In response to gradual tightening of the marginal reserve requirement measure, banks raised their interest rates on deposits in an effort to expand their domestic sources of growth, while unfavourable developments in the foreign markets spilled over into higher borrowing expenses. The observed rise in interest rates reduced the interest rate spread from 2.8 percentage points in 2006 to 2.6 percentage points in 2007 (Figure 3.13). Although the rise in deposit interest rates began to make larger impact on bank lending interest rates at the end of 2007, the increase in the average interest income was not strong enough to offset the effects of the growth in the average interest expenses.

General operating expenses (general administrative expenses and depreciation) were 10.2% higher at the end of 2007 than at the end of 2006. However, the higher growth rate of net income contributed positively to the cost efficiency of banks, as evidenced in the decline of the cost to income ratio (from 54.9% to 52.1%). In 2007, the cost to income ratio rose in small banks, which usually report the highest ratio value, while it fell in medium-sized and large banks.

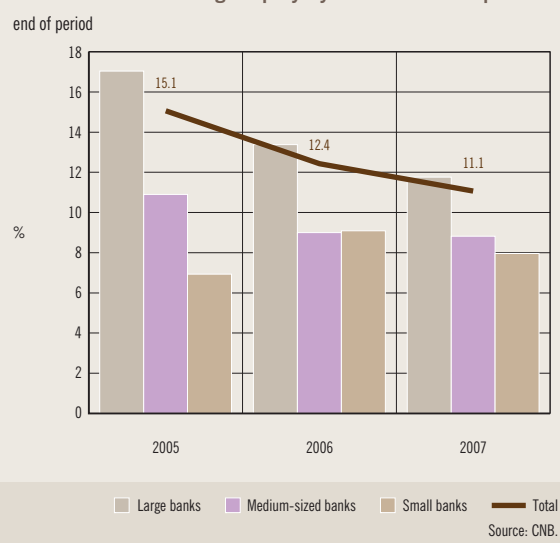
More than a half of the overall increase in general operating expenses was accounted for by higher expenses for bank employees (10.2%), the number of which rose by 7.9% in 2007 (from 19,096 to 20,613). Assets per employee increased from HRK 16.0m at the end of 2006 to HRK 16.7m at the end of 2007, growing annually by 4.9%. Lower than the average, assets per employee rose by 3.3% in large banks. They were the largest in small banks (11.4%) due to the low growth rate of the number of employees in this group of banks (6.8%).

Total expenses on loss provisions were 37.7% higher at the end of 2007 than at the end of 2006. The main reason for this was the increase in provision expenses on identified losses from HRK 204m to HRK 503m. However, collectively assessed impairment provisions dropped by HRK 43m in the reference period. Higher provision expenses for identified losses are attributed to the growth in non-performing placements and contingent liabilities (categories B and C) of 7.5%. As non-performing placements and contingent liabilities fell in medium-sized and small banks in 2007 relative to 2006, the overall growth in non-performing placements and contingent liabilities was the result of their growth in the group of large banks (12.4%). The growth in non-performing loans, especially non-performing household loans (7.0%), made the largest contribution to the rise in non-performing placements and contingent liabilities.



Improved management of expenses and greater profit-making capacity of assets increased the return on average assets (ROAA⁷) to 1.6% in 2007. By contrast, the return on average equity (ROAE) decreased from 12.4% to 11.1%, due mainly to substantial bank recapitalisations in 2007 and the increase in banks' share capital of more than 50%. The income growth rate of small banks stood at a low 3.7% in 2007, decreasing their ROAA from 1.4% to 1.3%. Although higher in 2007 than in 2006, ROAA remained the lowest in the group of medium-sized banks (1.2%), while large banks again reported the highest ROAA (1.7%). ROAE trended downward in all groups of banks. It fell most in the group of large banks (from 13.4% to 11.8%). The main contributor to this was the declined in ROAE in one bank in this group (to 4.4%) due decrease in its income and large recapitalisation in 2007.

3.16 Return on Average Equity by Bank Peer Groups



3.1.5 Banks' Liquidity

The share of household deposits in total bank deposits decreased further in 2007, with an almost equal rate of growth being recorded in the share of corporate deposits. Owing to a high growth rate of CBRD deposits and deposits of non-banking financial institutions, deposits of financial institutions grew at an exceptionally strong rate in 2007, increasing their share in total deposits.

Table 3.10 Banks' Liquidity Ratios

end of period, in %

	2005	2006	2007
Loans extended/Deposits received	88.5	92.5	92.8
Loans received/Total assets	19.2	18.0	15.0
Net interbank position	3.7	3.3	5.3

Source: CNB.

Notwithstanding the rise in interest rates on deposits, the deposit growth rate fell from 18.2% in 2006 to 14.9% in 2007. With (net) loans extended growing at a rate of 15.3%, the loan to deposit ratio continued to trend up in 2007 (Table 3.10), while the share of loans extended in total bank assets reached as much as 62.8%. The narrower room for managing liquidity, higher expenses and tighter limitations on foreign borrowing resulted in larger interbank lending and borrowing from the CNB and were accompanied by a rise in interest rates on the money market.

After a sizable reduction in loans received from non-residents (Table 3.11), total balance of received loans fell additionally in 2007 relative to 2006, contributing to a decrease in the share of received loans in total assets. The decrease in deposits and loans received from non-residents was above all the result of the fall in deposits and loans received from majority foreign owners. Thanks to bank recapitalisations, this reduction in the sources of financing did not cause any major disturbances in banks' operations. Hence, banks kept safe their sources of growth and strengthened their capital positions, i.e. solvency.

⁷ ROAA is calculated from income before taxes, and ROAE from income after taxes.

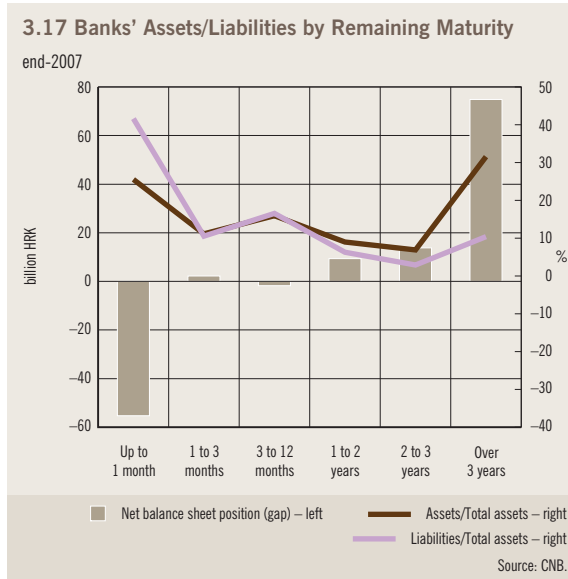
Table 3.11 Structure of Loans Received by Banks

end of period, in million HRK and %

	2005			2006			2007		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
Loans from government units	528.0	1.1	-22.3	272.9	0.5	-48.3	183.3	0.4	-32.8
Loans from financial institutions	13,844.2	27.7	63.6	15,102.5	27.5	9.1	20,338.6	39.2	34.7
Loans from enterprises	40.8	0.1	1.2	0.0	0.0	-99.9	0.0	0.0	-2.2
Loans from foreign financial institutions	35,143.1	70.2	16.8	39,489.9	72.0	12.4	31,117.8	60.0	-21.2
Loans from other non-residents	479.3	1.0	-15.4	360.5	0.7	-24.8	248.3	0.5	-31.1
Total loans received by banks	50,035.4	100.0	25.6	54,865.4	100.0	9.7	51,888.1	100.0	-5.4
Loans from majority foreign owners	17,705.0	35.4	45.9	22,925.5	41.8	29.5	17,509.3	33.7	-23.6

Source: CNB.

The analysis of the maturity (mis)match between assets and liabilities⁸ showed a characteristic deficiency of assets over liabilities (negative gap) in the category of remaining maturity of up to one month (Figure 3.17). The negative gap in the category of remaining maturity of one to three months, present in 2006 and 2005, shifted into positive territory in 2007, while the negative gap in the category of remaining maturity of three to twelve months was less pronounced in 2007 than 2006. Owing to these developments, the cumulative short-term maturity gap (up to one year; shown as a share in assets) fell modestly. Concurrently, the positive gap in the category of remaining maturity of two to three years and in the category of remaining maturity of more than three years trended up, with the cumulative long-term maturity gap (more than three years) increasing its share in assets from 10.3% to 12.5%. These developments are attributed to the increase in long-term bank placements and, especially, to the growth in home loans.



3.2 Housing Savings Banks' Business Operations

At the end of 2007, five housing savings banks operated on the territory of the Republic of Croatia. Total housing savings banks' assets stood at HRK 6.5bn at the end of 2007, a rise of 2.7% over the end of 2006. Compared with the end of 2006, three housing savings banks reported an increase and two housing savings banks reported a decline in their assets.

The share of housing savings banks' assets in total banking sector assets fell by 0.2 percentage points at the end of 2007 relative to the end of 2006, totalling 1.9%. The main contributor to this was slower growth in housing savings banks' assets than in total bank assets. Moreover, the share of housing savings banks' assets in total banking sector assets trended downward after reaching its record high in 2005 (2.3%).

Except for one housing savings bank in majority state ownership, all other housing savings banks were directly or indirectly in majority foreign ownership, accounting for 99.1% of total housing savings banks' assets in 2007. Three housing savings banks were in majority Austrian ownership, and their assets made up 77.9% of total housing savings banks' assets at the end of 2007. The housing savings bank in majority Italian ownership held the second largest share in total housing savings banks' assets (21.2%), while the housing savings bank in state ownership held the remaining share of 0.9%.

⁸ It represents the difference between net assets and liabilities (not including capital) with the same period until maturity.

3.2.1 Housing Savings Banks' Balance Sheet

In contrast to several previous years when investment in securities accounted for the largest share in housing savings banks' assets, the share of net loans exceeded the share of securities for the first time at the end of 2007. With housing savings deposits trending downward since the first half of 2007, the growth in loans was to a large extent facilitated by lower investment in securities. Hence, the restructuring of placements contributed to a strong annual growth of net loans (82.8%), increasing their share in total housing savings banks' assets from 28.0% at the end of 2006 to 49.8% at the end of 2007.

Table 3.12 Structure of Housing Savings Banks' Assets

end of period, in million HRK and %

	2005			2006			2007		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Money assets and deposits with the CNB	0.0	0.0	–	0.0	0.0	–	0.0	0.0	–
1.1. Money assets	0.0	0.0	–	0.0	0.0	–	0.0	0.0	–
1.2. Deposits with the CNB	0.0	0.0	–	0.0	0.0	–	0.0	0.0	–
2. Deposits with banking institutions	720.5	11.7	116.8	111.5	1.8	–84.5	47.1	0.7	–57.8
3. MoF treasury bills and CNB bills	782.0	12.7	0.2	347.7	5.5	–55.5	255.5	3.9	–26.5
4. Securities and other financial instruments held for trading	390.6	6.4	56.1	284.4	4.5	–27.2	176.7	2.7	–37.9
5. Securities and other financial instruments available for sale	706.8	11.5	–67.1	1,058.3	16.6	49.7	1,246.4	19.0	17.8
6. Securities and other financial instruments held to maturity	869.6	14.2	58.6	1,303.3	20.5	49.9	871.2	13.3	–33.2
7. Securities and other financial instruments not traded in active markets but carried at fair value	1,382.5	22.5	–	1,260.6	19.8	–8.8	528.4	8.1	–58.1
8. Derivative financial assets	0.0	0.0	–	5.4	0.1	–	6.7	0.1	23.3
9. Loans to financial institutions	263.7	4.3	–43.8	69.9	1.1	–73.5	86.5	1.3	23.8
10. Loans to other clients	727.6	11.9	95.1	1,713.0	26.9	135.4	3,172.1	48.5	85.2
11. Investments in subsidiaries, associates and joint ventures	0.0	0.0	–	0.0	0.0	–	0.0	0.0	–
12. Foreclosed and repossessed assets	0.0	0.0	–	0.0	0.0	–	0.0	0.0	–
13. Tangible assets (net of depreciation)	8.2	0.1	–6.1	7.0	0.1	–14.4	8.0	0.1	15.0
14. Interest, fees and other assets	323.8	5.3	–16.8	250.8	3.9	–22.5	194.9	3.0	–22.3
15. Net of: Collectively assessed impairment provisions	36.9	0.6	59.9	40.5	0.6	9.5	50.1	0.8	23.9
Total assets	6,138.4	100.0	14.7	6,371.4	100.0	3.8	6,543.4	100.0	2.7

Source: CNB.

Household time deposits predominated in total financing sources of housing savings banks at the end of 2007, making up 92.3% of total housing savings banks' liabilities. After decreasing in the first half of 2007, deposits went up by 4.0% over the end of 2006, with the majority of that increase being materialised in the last quarter of 2007. These developments are attributed to the withdrawal of housing savings deposits in the third quarter of 2007 and the participation in T-HT's IPO, as well as to the increased payments into housing savings deposit accounts at the end of the year for the purpose of utilising the state incentives.

Loans extended to housing savings banks' clients rose by 71.3% at the end of 2007 relative to the end of 2006, accounting for HRK 2.2bn of the total, while the remaining HRK 1.0bn in net loans were extended to central government funds and banks. Accordingly, the share of housing savings banks' loans in total loans of the banking sector stood at 4.7% at the end of 2007.

Housing savings banks' investment in securities were 27.6% lower at the end of 2007 than at the end of 2006, while their share in total housing savings banks' assets stood at 47.0%. At the end of 2007, relative to the end of 2006, the share of securities in housing savings banks' assets declined by 19.7 percentage points. The securities portfolio was composed of two instruments: T-bills, accounting for 8.3%, and government bonds, accounting for 91.7% of total investment in securities.

At the end of 2007, securities were mainly classified in the available-for-sale portfolio (42.6%), which was the only portfolio to show the growth rate at the end of 2007 relative to the end of 2006 (18.3%). Other securities portfolios declined in the reference period, especially the portfolio of securities and other financial instruments carried at fair value through profit and loss and not traded in active markets (down 51.7%), accounting for 23.2% of all securities at the end of 2007. The portfolio of securities and other financial instruments held to maturity went down by 36.6%, making up 28.5% of all securities. Only 5.7% of securities were classified into the held-for-trading portfolio, which decreased by 37.9% at the end of 2007 relative to the end of 2006.

Table 3.13 Structure of Housing Savings Banks' Liabilities

end of period, in million HRK and %

	2005			2006			2007		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Loans from financial institutions	0.0	0.0	–	0.0	0.0	–	0.2	0.0	–
1.1. Short-term loans	0.0	0.0	–	0.0	0.0	–	0.0	0.0	–
1.2. Long-term loans	0.0	0.0	–	0.0	0.0	–	0.2	0.0	–
2. Deposits	5,514.7	89.8	16.6	5,803.6	91.1	5.2	6,038.4	92.3	4.0
2.1. Giro account and current account deposits	0.0	0.0	–	0.0	0.0	–	0.0	0.0	–
2.2. Savings deposits	0.0	0.0	–	0.0	0.0	–	0.0	0.0	–
2.3. Time deposits	5,514.7	89.8	16.6	5,803.6	91.1	5.2	6,038.3	92.3	4.0
3. Other loans	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	–
3.2. Long-term loans	0.0	0.0	–	0.0	0.0	–	0.0	0.0	–
4. Derivative financial liabilities and other financial liabilities held for trading	4.1	0.1	–15.8	0.0	0.0	–	0.0	0.0	–
5. Debt securities issued	0.0	0.0	–	0.0	0.0	–	0.0	0.0	–
5.1. Short-term debt securities issued	0.0	0.0	–	0.0	0.0	–	0.0	0.0	–
5.2. Long-term debt securities issued	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	–
7. Hybrid instruments issued	10.3	0.2	–3.5	61.7	1.0	497.5	39.9	0.6	–35.3
8. Interest, fees and other liabilities	389.0	6.3	–14.1	312.5	4.9	–19.7	222.0	3.4	–29.0
Total liabilities	5,918.1	96.4	13.9	6,177.8	97.0	4.4	6,300.4	96.3	2.0
Total capital	220.2	3.6	42.3	193.6	3.0	–12.1	243.0	3.7	25.5
Total liabilities and capital	6,138.4	100.0	14.7	6,371.4	100.0	3.8	6,543.4	100.0	2.7

Source: CNB.

Assets denominated in kuna and indexed to foreign currency comprised the largest share of housing savings banks' assets, standing at 92.9% at the end of 2007.

The ratio between received deposits and extended loans amounted to 54.0% at the end of 2007. Compared with the end of 2006, it went up by 30.7%, largely due to higher growth in loans than in deposits. At the household sector level, only 36.7% of housing savings deposits were channelled into loans at the end of 2007.

3.2.2 Housing Savings Banks' Capital

Total housing savings banks' capital amounted to HRK 243.0m at the end of 2007, trending up by 25.5% over the end of 2006. The share capital of housing savings banks rose by 24.2% in 2007 on account of their recapitalisations and thus made the largest contribution the overall increase in housing savings banks' capital.

Total capital of housing savings banks grew by HRK 49.4m at the end of 2007 relative to the end of 2006. The main contributors to this were the increase in share capital by a total of HRK 69.6m and the decrease in the current year loss by HRK 10.3m. The overall capital trends were negatively impacted by the increase in value adjustment losses on available-for-sale financial assets in three housing savings banks (HRK 43.4m). The rise in total capital of housing savings banks made no significant impact on its share in total housing savings banks' liabilities, which, at the end of 2007, stood at 3.7%.

Table 3.14 Structure of Housing Savings Banks' Total Capital

end of period, in million HRK and %

	2005			2006			2007		
	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
1. Share capital	203.4	92.3	0.0	287.5	148.5	41.4	357.1	147.0	24.2
2. Current year profit/loss	52.3	23.7	358.6	-54.5	-28.2	-204.2	-44.2	-18.2	-18.9
3. Retained earnings/loss	-53.6	-24.4	-15.4	-37.1	-19.2	-30.8	-15.9	-6.6	-57.1
4. Legal reserves	1.9	0.9	-44.5	2.3	1.2	19.6	2.5	1.0	8.1
5. Total reserves provided for by the articles of association and other capital reserves	0.0	0.0	-	0.0	0.0	-	0.0	0.0	-
6. Unrealised gains/losses on value adjustments of financial assets available for sale	29.9	13.6	100.0	-13.1	-6.8	-143.9	-56.5	-23.2	330.5
7. Reserves arising from hedging transactions	0.0	0.0	-	0.0	0.0	-	0.0	0.0	-
8. Previous year profit/loss	-13.6	-6.2	100.0	8.5	4.4	-162.6	0.0	0.0	-100.0
Total capital	220.2	100.0	42.3	193.6	100.0	-12.1	243.0	100.0	25.5

Source: CNB.

Regulatory capital of housing savings banks totalled HRK 29.1m at the end of 2007, increasing by 11.8% over the end of 2006. Following a wave of recapitalisations in 2007, the core capital of housing savings banks rose by 22.7%. In addition, their supplementary capital I fell by 21.6% in 2007 due to the decrease in hybrid instruments and the exclusion of a portion of collectively assessed impairment provisions from regulatory capital.⁹ The observed increase in core capital was negatively impacted by a substantial increase in items deducted (16.9%), with unrealised value adjustment losses on available-for-sale assets accounting for a lion's share of HRK 56.5m. The unrealised value adjustment losses on available-for-sale assets were reported by three housing savings banks, including two housing savings banks which showed income before taxes at the end of 2007. Total unrealised losses were for the most part the result of operations of one housing savings bank whose assets were mainly accounted for by investment in securities, predominately classified into the held-for-trading portfolio.

Notwithstanding the increase in regulatory capital, the capital adequacy ratio of housing savings banks fell from 18.66% at the end of 2006 to 17.04% at the end of 2007. The main reason for this was the increase in foreign currency indexed home loans to the household sector, i.e. to the borrowers with unmatched foreign exchange positions. As a result, the exposure of housing savings banks to currency induced credit risk increased in 2007 and the net value of their assets weighted by risk grew by 2.7%. Concurrently, the weighted assets amount rose by 25.6% over the end of 2006, primarily due to a 72.7% increase in net assets weighted by a 75% risk weighting. Total capital requirements of housing savings banks grew at a lower rate in 2007 (22.4%) on account of smaller capital requirements for market risk, i.e. lower investment in securities.

3.2.3 Quality of Housing Savings Banks' Assets

Total placements and contingent liabilities of housing savings banks rose by 24.6% at the end of 2007 relative to the end of 2006. Concurrently, the quality of total placements and contingent liabilities of housing savings banks changed only slightly in the reference period. This was due mainly to an increase in fully recoverable placements (mostly loans to households), which also made the largest contribution to the overall growth in placements in 2007. Hence, fully recoverable placements grew by 24.4%, while partly recoverable placements and irrecoverable placements grew by a total of 175.4% at the end of 2007 relative to the end of 2006. Despite high growth in non-performing placements, their share in total placements and contingent liabilities of housing savings banks remained low (0.4%).

⁹ Decision on amendments to the Instruction for the uniform implementation of the decision on the capital adequacy of banks (OG 41/2006).

Table 3.15 Classification of Housing Savings Banks' Placements and Contingent Liabilities by Risk Categories

end of period, in million HRK and %

Placements	2005		2006		2007	
	Amount	Share	Amount	Share	Amount	Share
Fully recoverable placements (category A)	3,494.0	99.9	4,540.7	99.8	5,646.4	99.6
Partly recoverable placements (category B)	2.1	0.1	5.7	0.1	16.2	0.3
Irrecoverable placements (category C)	0.4	0.0	1.4	0.0	3.4	0.1
Total	3,496.5	100.0	4,547.8	100.0	5,665.9	100.0

Source: CNB.

At the end of 2007, HRK 5.3bn or 94.1% of net placements of housing savings banks were exposed to currency induced credit risk. This is attributed to the sectoral distribution of placements, i.e. to the regulatory provisions providing for that savings banks may place their funds with only two sectors – households and government units. As the foreign exchange positions of these two sectors are largely unmatched, net placements exposed to currency induced credit risk were mainly unhedged (93.0%), i.e. only 7.0% of exposed placements were hedged against that risk.

Like at the end of 2006, the ratio of total value adjustments and provisions to total placements and contingent liabilities stood at 1.0% at the end of 2007. The major contributor to this was a small share of non-performing placements in total placements and thus a small share of value adjustments in total value adjustments and provisions.

Table 3.16 Housing Savings Banks' Value Adjustments and Provisions

end of period, in million HRK and %

	2005	2006	2007
Total value adjustments against placements and provisions for contingent liabilities	38.4	44.8	57.8
– Value adjustments against placements and provisions for contingent liabilities	0.9	3.6	6.5
– Collectively assessed impairment provisions	37.5	41.2	51.2
Total placements and contingent liabilities	3,496.5	4,547.8	5,665.9
Relative ratio: total value adjustments and provisions/total placements and contingent liabilities	1.1	1.0	1.0

Source: CNB.

3.2.4 Quality of Housing Savings Banks' Earnings

At the end of 2007, housing savings banks had a loss before taxes to the amount of HRK 43.9m. Two housing savings banks reported total income of HRK 11.2m, while three housing savings banks reported total loss of HRK 55.1m.

Table 3.17 Housing Savings Banks' Income Statement

in million HRK and %

	2005		2006		2007	
	Amount	Change	Amount	Change	Amount	Change
Total interest income	241.0	17.4	264.9	9.9	301.5	13.8
Total interest expenses	169.7	18.2	186.8	10.1	195.2	4.5
Net interest income	71.3	15.4	78.0	9.5	106.3	36.2
Total income from fees and commissions	75.9	-15.8	78.6	3.5	77.2	-1.8
Total expenses on fees and commissions	8.0	5.0	10.0	25.2	11.4	14.2
Net income from fees and commissions	67.9	-17.8	68.6	1.0	65.8	-4.1
Other non-interest income	65.3	43.2	-50.5	-177.4	-43.5	-13.9
Other non-interest expenses	31.1	-23.7	34.3	10.5	30.4	-11.5
Net other non-interest income	34.2	604.4	-84.8	-347.8	-73.9	-12.9
Net non-interest income	102.2	16.8	-16.2	-115.9	-8.1	-50.2
General administrative expenses and depreciation	108.8	-7.8	113.7	4.5	128.4	12.9
Net operating income before loss provisions	64.6	107.2	-51.9	-180.4	-30.3	-41.7

	2005		2006		2007	
	Amount	Change	Amount	Change	Amount	Change
Expenses on value adjustments and provisions for identified losses	0.7	645.6	2.9	338.5	3.6	22.5
Expenses on collectively assessed impairment provisions	14.2	-15.9	3.8	-73.6	10.0	166.1
Total expenses on loss provisions	14.9	-12.3	6.7	-55.0	13.6	103.0
Income/loss before taxes	49.7	250.2	-58.6	-217.9	-43.9	-25.2
Income tax	-2.6	-191.6	-4.1	61.0	0.4	-108.5
Current year profit/loss	52.3	358.6	-54.5	-204.2	-44.2	-18.9

Source: CNB.

Total loss of housing savings banks was 25.2% lower at the end of 2007 than at the end of 2006. To a large extent, this was due to the restructuring of placements and smaller investment in securities. The loss from trading in securities, the loss from available-for-sale securities and the loss from securities carried at fair value through profit and loss and not traded in active markets amounted to HRK 48.9m at the end of 2007, which is a decrease of 26.2% over the end of 2006. However, the increase in the available-for-sale securities portfolio contributed to a concurrent increase in the unrealised value adjustment losses on available-for-sale assets (up HRK 43.4m or 330.5%). These changes had no negative impact on the operating results of housing savings banks in 2007. Specifically, in line with IAS 39, housing savings banks reported the incurred loss as their loss on capital and recognised it directly in their equity.

Net interest income of housing savings banks was 36.2% higher at the end of 2007 than at the end of 2006. Notwithstanding lower investment in securities and the resultant 13.3% decrease in income, interest income from investment in securities remained the largest source of income for housing savings banks in 2007. Thus, at the end of 2007, interest income from investment in securities amounted to HRK 164.6m and made up more than a half of total interest income (54.6%). In addition, thanks to larger lending volume in 2007, interest income from loans almost doubled in value in 2007. It accounted for 44.4% of total interest income at the end of 2007, up 21 percentage points over the end of 2006.

Total interest expenses went up by 4.5% in 2007, due mainly to higher liabilities on housing savings deposits. Net income from fees and commissions declined by 4.1% at the end of 2007 owing to a decrease in fees from banking services (1.8%) and a concurrent increase in expenses on fees and commissions (14.3%). General administrative expenses and depreciation rose by 12.9% in the reference period on account of larger expenses on employees (17.2%). Total expenses on loss provisions were two times higher at the end of 2007 than at the end of 2006. The main contributor to this was the growth in fully recoverable placements, prompting housing savings banks to increase their expenses on collectively assessed impairment provisions.

3.3 Supervision Report

In order to protect the savers and depositors and to maintain the stability and safety of the banking system, the Croatian National Bank supervises banks, savings banks, housing savings banks and credit unions. The supervisory tasks of the CNB also comprise the issuance and withdrawal of operating licences and other authorisations and approvals in accordance with the relevant acts,¹⁰ the adoption of relevant subordinate legislation and the supervision of operations of the stated institutions. The lawfulness and regularity of banks' operations and their capability to manage risks are assessed through on-site supervision, specialised on-site supervision and off-site supervision. The on-site supervision is carried out in accordance with a pre-determined supervision schedule or more frequently if any signs of non-compliance with standards are found or if a bank operating in the market is found to be more risky.

¹⁰ The statutory powers of the CNB in the field of supervision derive from the Act on the Croatian National Bank, the Banking Act, the Act on Housing Savings and State Incentives for Housing Savings and the Credit Unions Act.

3.3.1 On-Site Supervision

In 2007, on-site examinations and specialised on-site examinations were performed in 20 banks and 1 housing savings bank. A total of 31 on-site and specialised on-site examinations were carried out in banks and two non-banking financial institutions. In addition, 14 decisions requiring banks to eliminate the established violations and irregularities or to improve their condition were issued in 2007 on the basis of the completed examinations and the reports prepared thereafter.

In 2007, like in the previous years, full-scope on-site examinations were carried out in all small and medium-sized banks, while targeted on-site examinations were carried out only in large banks. Hence, a total of nine targeted on-site examinations were carried out in the course of 2007. The quality of assets was in the focus of six targeted on-site examinations. Liquidity and market risks were evaluated in three targeted on-site examinations, and earnings were examined within one targeted on-site examination. One targeted on-site examination also encompassed the recapitalisation of one bank, and one targeted on-site examination assessed an internal model for managing general interest rate risk, currency risk and risk of investment in equity securities.

In 2007, specialised on-site examinations were conducted in 13 banks. Moreover, in accordance with the statutory powers, on-site examinations were also carried out in two non-banking financial institutions. A total of 18 specialised on-site examinations were carried out in the course of 2007. Within this, four on-site examinations included the oversight of internal control systems, nine on-site examinations focused on the implementation of monetary and foreign exchange policy measures and one on-site examination assessed the AMA framework for operational risk.

3.3.2 Off-Site Analysis

The off-site analysis is focused on the monitoring of riskiness of bank operations. The assessment is predominantly based on the analysis of financial reports which banks submit to the Croatian National Bank.

In 2007, like in 2006, banks were obliged to submit quarterly reports on their capital, asset quality, earnings and liquidity. Accordingly, each analysed area was assigned a component rating, and each bank was assigned an overall composite rating. Component ratings for credit risk, liquidity risk and asset quality were also assessed in the light of banks' quality of management, their managing systems and the expertise of their management teams. However, the expertise of management teams was not separately rated. Overall composite ratings for banks also included component ratings for sensitivity to market risk. The implementation of the decisions, taken by the CNB on the basis of the submitted documentation, was also assessed in detail in the course of off-site analyses in 2007. Moreover, the booming non-banking financial sector and its ever increasing impact on banking operations pointed to the need of further development of off-site analysis of banking groups consolidated reports.

17 reports on established violations and 8 decisions requiring the implementation of measures were prepared and submitted in 2007 on the basis of analysed financial reports. Specifically, the stated reports were usually addressed to banks in breach of the limit on exposure to one person or persons in a special relationship with a bank.

In order to ensure timely exchange of information, the CNB held meetings with almost all external bank auditors in the last months of 2007. During the meetings, the external auditors informed the CNB on the results of their pre-audits and were briefed on those areas of bank operations which they were expected to control (audit) more closely in order to be able to design qualitative opinions. The cooperation with foreign supervisors of banking groups, an integral part of which are also domestic banks, continued in 2007 on the basis of the concluded memoranda of understanding.

3.3.3 Licensing and Market Competition

A total of 80 decisions on licensing and market competition issues were issued in the course of 2007. These included: prior approvals for performing the function of a member of the bank/savings banks management board, prior approvals for the acquisition of a qualifying holding, decisions on requests for granting a prior approval for

the establishment of a bank, authorisations for the establishment of a branch of a foreign bank, decisions on the permissible concentration level, and the like.

Furthermore, eight procedures covering the areas of market competition and consumer protection were carried out in 2007.

3.3.4 New Regulations on Banks' Business Operations and Supervision of Banks and Credit Unions

After entering into force in 2007, the Credit Unions Act¹¹ and the Act on Amendments to the Banking Act¹² created the necessary preconditions for the incorporation of new financial institutions (savings banks and credit unions) into the banking system of the Republic of Croatia. The supervision of these institutions is entrusted to the CNB. The Savings and Loan Associations Act¹³ ceased to have effect on the date of the entry into force of the Credit Unions Act. As a result, savings and loan associations were required to apply for a credit union or saving bank license until 31 December 2007 and 1 March 2008 respectively.

Out of 104 savings and loan associations in operation at the date of the entry into force of the Credit Unions Act, 37 savings and loan associations decided to transform themselves into credit unions, 43 into savings banks, and 20 opted for winding-up. Savings and loan association that opted to transform themselves into credit unions were required to submit their applications for a credit union license to the Croatian National Bank until the end of 2007. 18 applications, in accordance with which the relevant procedures for the issuance of licences were initiated, were received within the prescribed time-limit, while 19 savings and loan association subsequently decided to initiate the voluntary winding-up proceedings. Savings and loan associations that opted to transform themselves into savings banks were required to submit their applications for a saving bank license to the Croatian National Bank until 1 March 2008. After receiving five applications for a saving bank license and one application for the establishment of a new savings bank, the CNB initiate the relevant procedures.

In an effort to contribute to the reduction of operational risk, the CNB adopted the Guidelines for Managing IT Systems in March 2006. The objective of the Guidelines was to promote good practices and to advise banks on adequate IT management practices and procedures. As a step to that direction, the CNB adopted the Decision on adequate information system management in August 2007,¹⁴ regulating the criteria which banks (and savings banks) have to meet in order to adequately manage their information systems. The Act on Amendments to the Banking Act, adopted at the end of 2006 and in force as of 1 January 2007, provided the legal basis for its enactment.

Following the amendments to the Decision on the capital adequacy of banks,¹⁵ endorsed at the end of 2007, the use of unstable (secondary) sources of funds was tied up with the permissible growth rate of placements. In line with the amended Decision, banks with an above-average dependency on the secondary sources of funds are required to hold higher amounts of the primary sources of funds (i.e. capital and long-term household deposits) if they want to increase their placements at a faster rate. In addition, the risk weight on foreign currency loans and foreign currency indexed loans that are fully collateralised by residential mortgage and extended to clients with unmatched foreign exchange positions was increased from 75% to 100%, while the risk weight on foreign currency claims and foreign currency indexed claims on clients with unmatched foreign exchange positions was increased from 100% to 150%.

Activities aimed at harmonising Croatian legislation and subordinate legislation with the *acquis communautaire* continued at an accelerated pace in 2007. Consistent with that objective, the CNB prepared the draft Credit Institutions Act taking into account the relevant EU directives, new developments in the domestic regulatory framework

11 OG141/2006.

12 OG 141/2006.

13 OG 84/2002.

14 OG 80/2007.

15 OG 130/2007.

and the manner in which banks operate. When it enters into force, the Credit Institutions Act will replace the current Banking Act. In addition, the Credit Institutions Act will regulate more clearly and unequivocally certain matters, and thus eliminate ambiguities arising from the interpretation of the existing Act.

The CNB opened a public debate on its new regulatory framework in July 2007 by posting on its web site the draft Credit Institutions Act. The Credit Institutions Act is expected to be adopted in the course of 2008.

In November and December 2007, the CNB also posted on its web site the draft subordinate legislation on the matters contained in the draft Credit Institutions Act:

- Decision on the capital adequacy of credit institutions,
- Decision on the management of interest rate risk in the non-trading book,
- Decision on liquidity risk management, and
- Decision on own funds of credit institutions.

