CROATIAN NATIONAL BANK

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<u>Asset quality review confirms a high capital adequacy ratio of the observed banks and of the system as a whole</u>

The Asset Quality Review (AQR) of credit institutions in the Republic of Croatia, carried out in line with the recommendations of the European Banking Authority (EBA) and the European Central Bank (ECB) from October 2013, has shown that the established asset quality adjustment of credit institutions has a relatively small impact on the capital adequacy ratio of the observed credit institutions and the banking system as a whole. The reviewed banks, as well as the entire banking system of the Republic of Croatia, have a high capitalisation rate that provides credit institutions with the adequate protection against potential contingent losses and ensures them the necessary resilience to stress.

The AQR was carried out in Croatian credit institutions within the preparatory actions for two parallel, simultaneously conducted processes that covered the financial system of the European Union. These included the stress test of the European Banking Authority and the comprehensive assessment of the European Central Bank. Both processes were completed today with the publishing of the results, and they covered banking groups that also included all credit institutions in which the AQR was carried out in Croatia. The results of the AQR were incorporated in the stress test results.

For the four largest participating credit institutions (Zagrebačka banka d.d., Privredna banka Zagreb d.d., Erste&Steiermärkische Bank d.d. and Raiffeisenbank Austria d.d.), representing two thirds of the total assets of the banking system in Croatia, the capital adequacy ratio, at a consolidated level, on average would decrease by 0.6 percentage points as a result of additional value adjustments established by the AQR. For these four credit institutions, the Common Equity Tier 1 (CET1) capital adequacy ratio on average would stand at 19.9% and the total capital adequacy ratio at 20.2%, which is still much above the legally prescribed minimum and regulatory requirements of the CNB.

The AQR was carried out by a credit file review on a sample that covered exposures in the amount of HRK 40bn to 992 clients, by which it was established, *inter alia*, that the total exposure amount of HRK 2.9bn did not meet the conditions for the A exposures, as a result of which these should be considered as non-performing exposures. During the AQR, special emphasis was placed on the collateral value review and its adequate appraisal, as an important element to determine the adequacy of the formed value adjustments.

The described asset quality and collateral value review established the need for additional value adjustments of exposures in a total amount of HRK 1.25bn. In addition, using the projection of findings of the reviewed sample to the remainder of the portfolio, in accordance with the statistical approaches defined by the ECB, an additional HRK 1.57bn of non-performing exposures could be identified, that would require additional value adjustments of HRK 322m.

This means that total required value adjustments according to the AQR would amount to HRK 1.56bn, which is an increase of 8.9 percent, when compared with the total value adjustments made for non-performing exposures before the AQR was carried out.

By including all newly established non-performing exposures (those that are the result of the sample review and those resulting from the projection of these results to the remainder of the portfolio) for the credit institutions covered by the AQR, the share of non-performing exposures in the total exposures would increase from the average 11% to 12.4%.

It is worth mentioning that, in 2013, the four credit institutions included in the AQR generated total profit (before taxes) in the amount of HRK 2.5bn, and that their total costs of provisioning stood at HRK 4.2bn in the same year, while they totalled HRK 1.4bn in 2014 (by 30 June). It is therefore clear that a considerable share of value adjustments determined by the credit portfolio review under the AQR has already been entered in the books of these credit institutions in 2014.

The following links:

ECB: http://www.ecb.europa.eu/press/pr/date/2014/html/index.en.html

EBA: http://www.eba.europa.eu/-/eba-publishes-2014-eu-wide-stress-test-results

on the EBA and ECB websites, respectively, contain the published results of the stress test performed on the banking groups across the EU.

Below is a table with the key performance indicators of credit institutions included in the AQR and the AQR aggregate results, as well as the explanation of the methodology used in the AQR.

Table 1 Performance indicators of credit institutions included in the AQR as at 31 December 2013, at the level of the credit institution and at the consolidated level of a group of credit institutions *(in million HRK or %)*

	Name of institution	Credit institution's total assets on individual basis	Share in total assets, %	Total assets of credit institutions at consolidated level	Share in total consolidated assets of the system, %,	Credit institution's profit on individual basis (before taxes)	Credit institution's profit on consolidated basis (before taxes)	Capital adequacy ratio %, on individual basis	Capital adequacy ratio %, on consolidated basis
1	Zagrebačka banka d.d.	106,884	26.4	123,312	27.9	575	853	23.8	22.3
2	Privredna banka Zagreb d.d.	65,836	16.2	70,387	15.9	780	1,049	24.1	24.3
3	Erste&Steiermärkische Bank d.d.	60,125	14.8	67,854	15.3	90	263	16.5	15.2
4	Raiffeisenbank Austria d.d.	33,005	8.1	35,901	8.1	327	381	18.7	17.7
	Total 4 largest banks	**265,850**	**65.6**	**297,454**	**67.2**	**1,772**	**2,546**	**21.7**	**20.8**

Table 2 Results of carried out AQR on an aggregate basis for credit institutions in the Republic of Croatia (at consolidated level)

(in million HRK)

	Segment of exposure	**Total net exposure**		**Non performing exposures (NPE), on a gross basis**				**Impairment and value adjustments/provisions**					**Risk-weighted assets and capital**	
					Additionally identified NPEs during AQR			**Before AQR (12/2013)**	**Additionally identified value adjustments during AQR**			**After AQR**	**Before AQR (12/2013)**	
		Before AQR (12/2013)	**After AQR**	**Unadjusted NPE - before AQR (12/2013)**	**Changes due to the single credit file review**	**Changes due to the projections of findings**	**Adjusted NPE** (after AQR)**	**Unadjusted impairment and value adjustments (including performing exposures)**	**Value adjustments due to provisions on sample files**	**Value adjustments due to projection of findings**	**Total value adjustments determined in AQR**	**Adjusted impairment and value adjustments**	**Risk exposure *****	**CET1**
1	Central banks and central governments	38,915	38,915	42	-	-	42	233	-	-	-	233	8,692	
2	Institutions	55,437	55,437	114	-	-	114	515	-	-	-	515	4,566	
3	Corporates	92,409	91,162	24,448	2,937	1,571	28,955	12,348	1,247	322	1,569	13,917	73,705	
4	Retail	105,415	105,415	10,663	-	-	10,663	7,058	-	-	-	7,058	75,340	
	Total	**292,176**	**290,929**	**35,266**	**2,937**	**1,571**	**39,774**	**20,154**	**1,247**	**322**	**1,569**	**21,723**	**162,303**	**38,645**

* Net exposure represents on- and off-balance sheet exposure net of the value adjustments of exposures and off-balance sheet items

** NPE represents the so-called non-performing exposures or any exposures and off-balance sheet contingent liabilities that are considered as partly recoverable exposures (non-performing exposures)

*** Risk exposure refers to risk-weighted assets only for the subject exposure segments.

Methodology for the quality review of credit institutions' assets

In October 2013, the European Banking Authority published the ***Recommendations on Asset Quality Reviews*** (EBA/REC/2013/04[1]) issuing recommendations addressed to competent national authorities in the Member States requiring them to conduct AQRs on credit institutions as part of their supervisory oversight.

The objective of the *Recommendations* was to contribute to a more uniform approach in the evaluation of credit portfolios by national institutions competent for supervision, including adequate risk classification and determining value adjustments, in order to support sufficiently prudent capital levels to cover the risks associated with these exposures. In addition, the objective of the *Recommendations* was to eliminate doubts about the quality of banking assets, as well as capital in the EU (deterioration in asset quality and forbearance in the context of the deteriorating economic environment across the EU) using consistent definitions of non-performing exposures (NPEs), or forborne exposures (FBEs). The *Recommendations* concern the review of asset classes considered to be high risk in credit institutions' portfolios. The results of the conducted AQRs should be taken into account when carrying out the stress test defined by the EBA (the stress test includes a total of 123 banking groups across the EU covering a minimum of 50% of total banking system assets at the level of each Member State[2]).

Parallel with the publishing of EBA's *Recommendations on Asset Quality Reviews*, the European Central Bank (ECB) released the document ***Note Comprehensive Assessment October 2013***[3] on 23 October 2013, by which it announced the carrying out of a comprehensive review and appraisal of the assets of credit institutions in the Member States, over which the ECB would assume its supervisory role in November 2014 (that is, as of the entry into force of the regulatory framework defining the single supervisory mechanism (SSM)). The ECB's comprehensive assessment comprises three pillars: a supervisory assessment of credit institutions' intrinsic risk profile (the so-called RAS assessment), an AQR and a stress test (coordinated at the EBA level).

[1] Available on EBA's website: https://www.eba.europa.eu/documents/ 10180/449802/EBA-Rec-2013-04+Recommendations+on+asset+quality+reviews.pdf

[2] Available on EBA's website: https://www.eba.europa.eu/-/eba-announces-key-features-of-the-2014-eu-wide-stress-test.

[3] Available on ECB's website: https://www.ecb.europa.eu/pub/pdf/other/notecomprehensiveassessment201310en.pdf?065ff8953213aaf23e385c1119dd541a

It is worth noting that the Croatian National Bank is not required to conduct a stress test on its largest credit institutions according to the EBA's methodology, as the stress test is conducted at a consolidated level of the owners of the individual credit institutions. Nevertheless, the CNB conducts the stress test according to its own methodology adjusted to the specificities of the Croatian market and it regularly publishes the results in its publications.

However, the Croatian National Bank is required to implement EBA's *Recommendations on Asset Quality Reviews*, so that a decision on the carrying out of AQRs in line with the recommendations was adopted in December 2013. At the same time, although the Republic of Croatia does not participate in the SSM, due to the ownership structure of the largest Croatian credit institutions and the fact that they are members of the EU groups that will be under the responsibility of the ECB (and included in the ECB's comprehensive AQR), the CNB is included in the ECB's AQR, in co-operation with the consolidating supervisors of the participating banking group.

In December 2013, the Croatian National Bank issued a decision to include the four largest Croatian credit institutions (Zagrebačka banka d.d., Privredna banka Zagreb d.d., Erste&Steiermärkische Bank d.d. and Raiffeisenbank Austria d.d.) in the AQR, in line with the *Recommendations*. These credit institutions jointly account for 67% of the total assets of the Croatian banking system.

For the needs of a consistent execution of the AQR by national supervisors or by a third party, audit firms and/or other asset appraisal specialists, the ECB has prescribed and published the Asset Quality Review – Phase 2 Manual[4] according to which the AQR is executed. The methodology is described in the Manual in detail, and it is divided in ten workblocks:

1. Processes, policies and accounting review. The objective is to ensure that the credit institution has a robust set of policies and processes for the adequate implementation of accounting or industry standards, which, as a result, reflects on the showing of individual items in the financial statements of the credit institution;
2. Loan tape creation[5] and data integrity validation. The objective is to determine the most important or the most risky loan tapes for the individual credit

[4] http://www.ecb.europa.eu/pub/pdf/other/assetqualityreviewphase2manual201403en.pdf
[5] In addition to the Asset Quality Review Manual, the ECB also defined templates that the national examiners of the countries included in the SSM submitted to the parent credit institutions that were subject to a comprehensive AQR.

institution to enable the sampling of the clients to be reviewed on a case-by-case basis. At the same time, to ensure the quality of the submitted data in the populated templates, the ECB carries out defined procedures for the verification of accuracy and completeness of the submitted data or the adequate assignment of clients into loan tapes. During the actual review of clients' credit files in workblock 4, the quality of data is controlled additionally for each and individual client;

3. Sampling. The sampling approach is based on statistical techniques and is compliant with international audit standards. A sample should be taken for each selected loan tape from workblock 2. For sampling purposes, in each of the previously selected loan tapes (portfolio), clients are divided into 49 strata differentiated by the total level of exposure and by risk. On the basis of the matrix prepared in this way, ten largest clients are selected from each of the seven risk categories on the basis of exposure. The clients selected represent the main sample. Random sampling is used to form a statistical sample from the remaining clients in the portfolio from each stratum. These sampling approaches enable the projections of sample review findings to the remainder of the portfolio (the so-called extrapolation of findings);

4. Credit file review. The objective is to determine the accuracy of the shown data in the templates populated by a credit institution, to ensure the correctness of the assignment of clients to a loan tape and to determine whether an impairment test should be conducted or whether value adjustments that the credit institution has shown correspond to the impairment test conducted by the national examiner;

5. Collateral and real estate valuation. The objective is to determine whether physical asset valuations of real estate, movable assets and other collaterals used in the assessment of value adjustments or provisions are appropriate. For the physical collateral valuations to be considered as appropriate for the needs of conducting AQRs, they must not be older than one year from the reference date and should be conducted by an independent external appraiser. Otherwise, collaterals should be revaluated, while real estate should be valued in line with European Standards EVS-2012 (Blue Book) and other international standards such as the Royal Institute of Chartered Surveyors (RICS) guidelines;

6. Projection of findings of credit file review. In the event that the sample review establishes a deviation of 5% in relation to the rate of non-performing exposures or value adjustments/provisions that the credit institution has shown itself, it is necessary to prepare a projection of the findings based on the sample reviewed to

the remainder of the clients from the loan tape (portfolio) concerned for which the deviation has been identified;

7. Collective provision analysis. The objective is to assess the level of provisioning for losses on a collective basis. In order to assess the adequacy and to ensure a consistent approach, the statistical model defined by the ECB is used, the results of which are used to determine the adjusted level of the credit institution's CET1;

8. Level 3 fair value exposures review. The objective is to ensure that if the credit institution evaluates the fair value in accordance with the International Financial Reporting Standard (IFRS) 13, and if it does not, it is necessary to determine the material impact on the credit institution's CET1%ratio;

9. Determine AQR-adjusted CET1% and define remediation activities for credit institutions following the comprehensive assessment. The objective is to determine an "AQR-adjusted CET1%" ratio as an input to the stress test. Furthermore, conclusively with the conducted comprehensive assessment, a report should be produced on the remediation actions required that should be provided to the credit institution in the form of a letter to management requiring the prescribed actions in the subsequent periods;

10. Quality assurance and progress tracking. During the entire AQR, the submitted data are constantly verified to ensure the authenticity of data on which the AQR is based.

Twenty-five CNB examiners were engaged on the AQR project in the Republic of Croatia during an uninterrupted period of three months (March – June 2014). A total of 1200 examiner days were used in the AQR implementation. Due to the specificity of the project and the ownership structure of the credit institutions participating in the project, all activities and the implementation of the previously described workblocks were coordinated with consolidating supervisors. The role of CNB examiners was to participate in the direct supervision or support in the carrying out of the quality assurance of the implemented process in co-operation with Austrian examiners. In the case of the Italian consolidating supervisor, the CNB and Banca d'Italia agreed the division of responsibilities for the performance of the task, where the CNB was responsible primarily for the credit file review and for the support to the carrying out of other tasks, while the consolidating supervisor assumed the responsibility for other workblocks.