SURVEYS

The Lending Policies of Croatian Banks: Results of the Second CNB Bank Interview Project

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Summary

Using interviews with 47 of the 53 commercial banks operating in Croatia in early 2000, the project team asked banks asked about their experiences during the 1998-99 banking crisis. Banks commented on their experiences with outflows of deposits, breaking-up of deposits, and changes in management practices adopted to deal with the crisis. In addition, the project repeated and extended a previous survey on bank lending practices. The findings of this survey show that, while banks' written lending procedures have advanced considerably, many of the same problems in assessing risk, foreclosing collateral and finding funding for long-term lending remain.

JEL: G21; P27; P34; G34; E44

Key words: Banking; Croatia; Transition; Banking Crises; Lending Policy

The project team would like to thank all the bankers who participated in the survey for their cooperation.

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1. Introduction

A little more than 2 years ago, a team of researchers at the Croatian National Bank conducted a survey of the lending policies of Croatian banks (published in Croatian as CNB Survey #8, "Analiza kreditne politike hrvatskih banaka" and in English as CNB Survey #9, "Credit Policies of Croatian Banks"). That survey examined the roots of the rapid lending expansion seen in 1996 and 1997, and also attempted to shed light on the decision-making processes Croatian banks use in loan underwriting and collection.

In late 1999, it was decided that the time was ripe for another survey. Circumstances in the banking market had changed substantially, with the emergence of a banking crisis in 1998 and early 1999. Lending growth had virtually come to a halt, the number of banks in the market had begun to decrease noticeably. In addition, with the sale of majority stakes in three state-owned banks in late 1999 and early 2000, it was clear that a new phase was opening up in the development of the Croatian banking system.

The interviews discussed in this paper were held in February and March 2000. 47 of the 53 active banks in Croatia were interviewed.[1] The interviews provide a picture of how the banks currently active on the Croatian market-the banks that survived the banking crisis-managed to do so, what changes they made in their business policies, and what their lending practices are today. In addition, the interviews provided extensive information on the role that foreign banks have played so far in Croatia. Given the substantial foreign acquisitions in recent months, there is no doubt that this role will increase in quantity and change in quality in the next few years. But this survey will provide a snapshot of the status of the system just before this major structural change.

The interviews were conducted on the basis of a pre-determined set of questions. The bankers interviewed were not given the questionnaire beforehand, and were not asked to give exact numbers. Therefore, the answers represent bankers' own assessments, rather than balance sheet data.

To make our presentation more manageable, we have broken our report into two parts. The part you are reading deals with the banking crisis, lending policies and other related issues affecting the banking system. A second, separate part deals with the impact of foreign banks. This part will also be published as a CNB Working Paper.

1 The banks not interviewed fell into two categories: four banks whose accounts were blocked and seemed to be facing imminent bankruptcy, and two smaller banks about to be merged into a larger bank.

2 When a bankruptcy procedure is opened in court for a bank, the bank's license is revoked and its assets and liabilities are no longer counted in the total banking system.

2. Background: The Banking Crisis

As of December 31, 1999, the Croatian banking system included 53 institutions with total assets of 93.8 billion kuna. The following indicators are suggestive of recent trends in the banking system.

Table 1: Indicators of the Croatian banking system

	1997	1998	1999[a]
Number of banks	60	60	53
Total banking assets (bill HRK)	88.9	96.8	93.8
Total off-balance sheet items	70.4	58.2	42.3
Capital adequacy ratio, %	16.4	12.7	19.3
Return on assets, %	1.2	–2.8	0.8
Return on equity, %	9.6	–30.6	6.7
Net interest margin, %	3.4	4.2	4.2
Growth of loans, %	40.1	17.6	–7.4
Growth of deposits, %	21.2	5.0	–2.0
Percentage of "A" assets in total risk assets and off-balance sheet items	88.8	85.1	86.0

[a] Preliminary data.
Source: Croatian National Bank

Looking at the major trends, it is clear that the rapid growth in total assets, loans and deposits of 1997 slowed substantially in 1998 and was even reversed in 1999. Much of the decrease in 1999 is explained by the initiation of bankruptcy procedures in 7 banks during that year.[2] The emergence of the banking crisis is also seen in the drastic drop in profitability and the substantial decrease in asset quality in 1998.

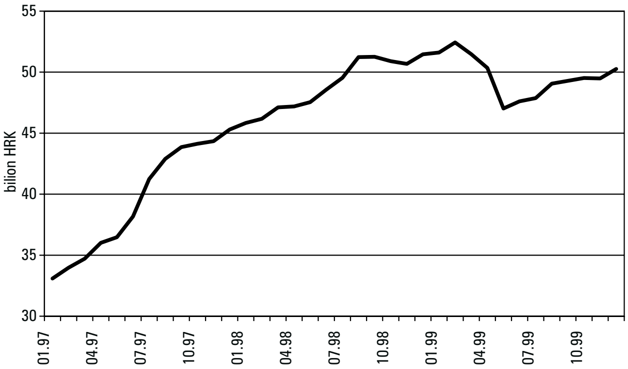
The banking crisis began in spring 1998 with the failure of Dubrovačka banka.[3] There were runs on two other banks in the ensuing months, and the exchange rate of the kuna against the German mark began to deteriorate as savers lost confidence in the banking system and the currency. After a short respite during the summer, the depreciation continued in the fall of 1998 and on into February of 1999.

At the same time, the economy fell into recession beginning in the last quarter of 1998. The decrease in new bank lending was clear one factor, as was a growing epidemic of non-payment, illiquidity and financial indiscipline. The recession and the banking crisis were deeply interrelated, feeding and exacerbating each other.

In December 1998, the new Banking Law was passed by the Croatian Parliament. This law greatly increased the Croatian National Bank's ability to intervene in problem banks. Among other things, it gave the CNB the right

3 For more detailed studies of the banking crisis, see Kraft (1999), Jankov (2000) and Croatian National Bank (1999).

Graph 1. Total deposits 1997-99



Source: CNB

to appoint a commissioner in banks whose capital is impaired but remains solvent, and it gave the CNB the right to appoint a temporary administrator in insolvent banks. These measures also made it substantially easier for the CNB to request the initiation of bankruptcy procedures, and decreased the possibilities for bank rehabilitation.

Using the powers granted to it by the new law, the CNB sent temporary administrators to four banks in January 1999, and requested the initiation of bankruptcy procedures in these four banks in March. This, coupled with the failure of two more banks, caused a crisis of confidence, with total bank deposits falling starting in February. Deposits finally stabilized in May, and it became clear that a systemic crisis had been (barely) averted.

3. Banks' Response to the Crisis

Although the Croatian National Bank receives data from banks regarding their deposits on a monthly basis, we decided to ask banks whether they had experienced outflows of deposits during the crisis. We did this partly to see what bankers' subjective impressions were, and also because important withdrawals and return of deposits can occur even within a monthly period.

Table 2: Deposit outflows during the banking crisis

	Number	% sample banks	% sample assets
Experienced no outflows	15	31.9%	37.8%
Experienced outflows	26	55.3%	57.6%
Experienced inflows	5	10.6%	4.3%
No answer	1	2.2%	0.3%

The responses show that the majority of banks experienced outflows. They also suggest that both large and small banks were affected by this phenomenon. It is noteworthy that all five of the banks that reported inflows were foreign banks, indicating that some depositors saw foreign banks as safer during the crisis.

The widespread nature of the deposit outflows also suggests that a considerable amount of contagion was present during the crisis. That is, savers did not only withdraw their money from failing banks; instead, due to general uncertainty about the direction of the crisis and the soundness of the system, savers to a certain extent panicked and withdrew their money from otherwise sound banks. Had this process gone further, systemic problems could have occurred, causing further bank failures. Fortunately, a general panic was avoided.

When discussing savers' perceptions about the safety of their deposits, it is important to see whether the presence of deposit insurance decreased savers' propensity to "run." One aspect of this process that can be observed is to see whether holders of large deposits at any point broke up their deposits to make sure that all their savings were covered by deposit insurance. This can be done in several ways. One way that was observed among failed banks was taking a large deposit in one individual's name and breaking into several smaller deposits, each in the name of a different family member.

Table 3: "Breaking-up" of deposits

	Number	% sample banks	% sample assets
Noted breaking-up	11	23.4%	19.7%
Did not note breaking-up	27	57.5%	38.5%
No answer	9	19.1%	41.8%

The relatively small amount of breaking up of deposits does seem to show that savers either 1) did not believe that the government would allow the bank to fail or their money to be lost or 2) did not believe that deposit insurance would actually be provided. Although it is logically possible that savers made sure that their money was insured through different means, such as withdrawing some from one bank and placing the surplus in another bank, our conversations with bankers and other anecdotal evidence lead us to believe that this did not happen.

In light of the slowness with which deposit insurance has been paid (or rather, not paid), it seems that the credibility of deposit insurance and its effectiveness in preventing bank runs is limited in Croatia. This finding must be taken into account in future discussions of deposit insurance and the stability of the banking system in Croatia.

The previous paragraphs have discussed the behavior of savers in the banking crisis. What about the behavior of banks?

Table 4: Changes in bank behavior during the crisis

	Number	% sample banks	% sample assets
Changed lending policy	19	40.4%	62.2%
Improved liquidity management	18	38.3%	38.3%
Improved cost management	14	29.8%	28.9%
Enforced stricter loss provisions	13	27.7%	27.8%
Decreased employment	12	25.5%	10.5%
Lowered lending interest rates	10	21.3%	4.6%
Increased capital	9	19.2%	10.8%
Increased employment	7	14.9%	9.9%
Stopped lending	6	12.8%	4.6%
Decreased number of branches	4	8.5%	6.9%
Increased number of branches	4	8.5%	3.2%
Lowered deposit interest rates	2	4.3%	3.0%
Raised deposit interest rates	2	4.3%	2.3%

For the most part, the answers are easy to interpret. Perhaps seeing the problems of others, banks tightened their lending criteria and were stricter about provisioning for losses. And, faced with more liquidity and profitability problems, they sought to improve their liquidity management, improve cost management, and decrease employment.

The only responses that are a little unusual are the banks that increased employment, and those that lowered deposit interest rates. Increased employment may have been an attempt to improve the banks' branch networks and thereby increase the deposit base, or to open new, profitable lines of business. Presumably the banks that adopted such strategies were not the ones in the most dire straits, since increased employment requires higher outlays.

Regarding the decrease in deposit interest rates, the banks that did this apparently were trying to signal that they were different than the failed banks, many of whom had offered extremely high deposit interest rates. In fact, in one case, a bank told us that lowering deposit rates was the key to restoring saver confidence.

Some banks remarked that they did not change their policies during the crisis at all, since the policies were generally adequate. Instead, they noted that changes were made in certain parameters, such as the desired rate of growth of total loans, or the amount of liquidity needed. This answer implies that such banks also adjusted to the crisis, the only difference being that the framework provided by bank policies was better developed and did not have to be fundamentally changed.

A related question is how banks dealt with the increasing inability of their customers to repay loans on time.

Table 5: How did you respond to slower repayment of loans?

	Number	% sample banks	% sample assets
Reprogram loans more often	20	42.3%	29.1%
Tolerate more lateness	18	38.3%	14.7%
Accept goods in compensation more often	17	36.2%	23.9%
Activate collateral sooner	16	34.0%	24.9%
Invest more in safe assets (Ministry of Finance or CNB bills)	15	31.9%	22.6%
Rely more on lines of credit	8	17.0%	19.4%

The answers indicate that a number of banks have adapted to worse repayment by relaxing their criteria. Reprogramming may be the best way to salvage a bad situation, but it does involve losses for the bank. Accepting goods is clearly risky, particularly in a situation in which finding people willing to pay cash for anything is difficult. Activating collateral sooner, by contrast, indicates less willingness to tolerate client tardiness in payments, and signals a more aggressive approach by banks. Finally, increased investment in safe assets reflects recognition of the greater risk in ordinary lending.

It would be interesting to examine more closely how each of these responses has helped banks to survive. However, the data from our research do not allow for more detailed analysis. Instead, they suggest that banks have adapted in different ways, some involving accepting that the economic environment has deteriorated, and others involving efforts to decrease risk and to take a more aggressive approach to debt collection.

4. Lending Policies

4.1 Written policies

The purpose of written lending policies is to ensure that customers receive uniform treatment from all representatives of the bank, and to establish clear policies and procedures. Best practice calls for extensive written policies detailing all relevant procedures in the lending process.

Under the Banking Law, banks are required to have, as a part of their general statutes, "lending policies that determine the procedures and manner for granting loans, other placements and potential liabilities, as well as the procedures and manners of assuring repayment of claims, the calculation and collection of interest, fees and other remuneration as well as procedures related to other aspects of exposure provided for in this law" (Article 76, paragraph 6). Also, banks are required to write a "policy of asset and liability management, measures for management of liquidity, interest rate risk and exchange rate risk" (Article 76, paragraph 7).

Thanks to these requirements, banks have expended extra efforts on their written lending policies in the last two years. We applied essentially the same set of criteria to rate banks credit policies that we used two years ago and found signs of improvement.

Table 6: Average scores for selected policy components

	Second survey	First survey
1. Risk diversification goals	0.9	0.3
Currency and maturity	0.8	na
2. Types of credit offered	1.5	1.3
3. Interest rates and fees	1.3	0.9
4. Size limits	1.4	1.0
5. Documentation required	1.7	1.4
6. Collateral	1.8	1.3
7. Decision criteria and authority	1.7	1.3
8. Contract contents, termination	0.7	0.6
9. Follow-up	1.2	0.3
10. Repayment and prolongation procedures	0.9	0.6
11. Exceptions, related parties	0.6	0.3

0=no mention, 1=superficial coverage, 2=detailed coverage. N=46 in second survey, 42 in first survey

Note: The averages are unweighted.

1. *Risk diversification goals*: stated goals for diversification of asset portfolio by economic sector or geographical region. Currency and maturity: instructions for managing exchange rate and interest rate risk.
2. *Types of credit offered*: explicit explanation of forms of credit such as short-term, working capital, investment, consumer etc.
3. *Interest rates and fees*: explanation of interest charges and additional fees relevant to each category of loan.

4. *Size limits*: mention of limits on the size of individual loans or exposures to individual borrowers.
5. *Documentation required*: clear description of documentation required to obtain loan.
6. *Collateral*: statement of types of collateral accepted for particular loans; determination of collateral to loan ratios; statement of other requirements such as insurance of collateral, court registration of collateral.
7. *Decision criteria and authority*: basis on which loan decision is made; statement of who authorizes lending.
8. *Contract contents, termination*: clear elaboration of elements in loan contract and conditions under which contract may be terminated.
9. *Follow-up*: description of how contacts with client are documented and who monitors credit repayment.
10. *Repayment and prolongation procedures*: description of procedures in case of nonpayment, and procedures for prolongation.
11. *Exceptions, related parties*: description of circumstances under which exceptional treatment may be granted and requirements for loans to related parties.

In 2000, documentation required, collateral and decision-making authority tend to be fairly extensively explained in written credit policies. The types of loans offered are also spelled out in some detail. These are all very important areas, and the advances made here are certainly significant.

Very substantial progress was made in detailing follow-up procedures, so that these are now somewhat defined in written policies. Also, interest rates and fees are fairly clearly set out, although some banks do not give much information on this in written materials. This is probably not a crucial omission, since such information can be circulated in a bank frequently through circulars, interest rate lists and the like.

Where banks' written policies continue to lag somewhat are the areas of risk goals, contract termination, repayment and prolongation, and related party lending. These are all very important areas. The continued weakness of banks' policies in setting risk goals in part reflects the thinking of local banks, which see no point in specifying rigid sectoral lending priorities. Such banks also have no special geographical goals, since they do not intend to expand beyond a limited region.

Even taking this into account, however, there is a strong case for banks monitoring bank exposures by economic sector and attempting to manage concentration. This can be done via a diversification approach, or via a specialization approach, but in any case should be part of a whole risk management strategy tied into the bank's basic business policy.

Furthermore, there are many larger banks in Croatia that still do not seem to monitor sectoral exposures at all. In some cases, weaknesses in information systems prevent such monitoring from being effective. However, lack of information about sectoral concentrations can lead to excessive risks being taken, and endanger bank soundness.

In this report, we did add a new subcategory to the risk diversification group: interest rate risk and exchange rate risk. We found that banks' written policies covered these areas rather superficially, in a similar fashion to sectoral and geographic concentration. Given the high degree of exchange rate risk assumed by Croatian banks, this too is worrisome. Furthermore, little is known about the extent of interest rate risk assumed by Croatian banks, so this is an area banks should consider examining in more detail in the near future.

Even though we added an extra subcategory, we adjusted the weighting scheme we had used in the previous report so that the maximum number of points remained the same. This allows us to directly compare the results by size categories for both surveys. (For details of the weighting scheme, see Appendix 1.)

Table 7: Synthetic index of written lending policies

By number of employees	Second survey	First survey
Less than 50 employees	14.3	9.0
50 to 200 employees	13.4	10.3
More than 200 employees	14.8	12.0
By total banking assets		
Less than 200 million HRK	12.5	8.3
200 to 500 million HRK	14.2	11.6
Above 500 million HRK	14.3	11.3
All banks	13.9	10.5

The table shows that substantial improvement can be seen, especially among smaller banks. The pattern that smaller banks have less complete lending policies is beginning to change, as evidenced by the fact that banks with less than 50 employees actually have more detailed policies on average than banks with 50 to 200 employees. In fact, there is substantial heterogeneity within each category; there are small banks with very detailed and clear policies, and small banks with very sketchy and limited policies. The same is actually true for large banks as well.

It appears that, thanks to the Banking Law, the days of banks operating in Croatia without written lending policies, or with minimal policies, are ending. However, the question remains: does the practice measure up to what is on paper?

4.2 The actual lending process

In our previous report, we noted that Croatian banks have significant information problems that make it difficult to assess the creditworthiness of clients. The situation has not changed substantially in the last two years. Croatian banks still do not know whether clients have loans at other banks, nor whether they have served as guarantors for other loans. Furthermore, banks do not have ways to know whether clients have repaid loans from other banks regularly, and phenomenon such as multiple gyro accounts continue to be a problem.

Although the Banking Law provided that a Credit Register be set up, to the time of writing this has not been accomplished. Although it is not a panacea, a Credit Register could solve many of the problems mentioned above. At least, a firm or individual's record of repayment and current obligations could be followed, so that bad debtors would not be able to move from bank to bank, causing a series of losses.

The other major information limitations affecting Croatian banks are the fact that small firms are not required to compile audited income statements; the general unreliability of income statements due to inadequate accounting practices and the considerable amounts of gray economy activity which distorts the formal written income statements and tax returns of many economic subjects.

In this situation, Croatian banks continue to require clients to submit large amounts of paperwork when asking for a loan. Loan applications typically include the client's court registration, the signature card with ZAP, up-to-date BON 1 and BON 2 forms showing that the client's gyro account has not been blocked and offering a basic analysis of financial ratios, tax returns, business plans, cash flow projections, and several years of income statements and balance sheets.

Regarding the relevance of past business history, banks seem to have somewhat increased the number of previous income statements they want to see. Whereas two years ago, there were many banks willing to rely on only 1 year of past income statements, now most banks require at least 2. The table below shows that the larger banks tend to require 3 years, or even more.

Table 8: Number of years of income statements required

	Number	% sample banks	% sample assets
Less than 3 years	24	51.1%	24.1%
3 years	16	34.0%	55.7%
More than 3 years	2	4.3%	17.5%
No answer	5	10.6%	2.7%

The shift to more years of income statements may reflect the greater stability of economic conditions in Croatia. Bankers seem to be saying that they expect the future to be similar to the past-something they were not willing to say even two years ago. Furthermore, the greater importance of longer-term lending may be pushing banks to look harder at past histories.

These figures, it should also be noted, are for new applicants. Many banks stated that they now have rather long histories on file for their older clients.

Another method of gathering information about clients is to visit them. Bankers report a much better sense of how serious a client is and of the nature of their business from going to visit them. Client visits allow a bank to distinguish how an applicant looks on paper from how they are in real life. They also allow banks to weed out certain blatant types of fraud, providing bankers with a greater sense of security about their clients.

Table 9: Frequency of client visits

	Number	% sample banks	% sample assets
Never visit clients	11	23.4%	8.9%
Regularly visit clients	17	36.1%	35.2%
Only visit new clients	15	31.9%	27.4%
No answer	4	8.5%	28.5%

The data show that most banks, and apparently most larger banks, visit their clients. Some use visits to get to know new clients, while others use visits both for getting to know new clients and for monitoring clients in an ongoing relationship. Some of the banks that do not visit stated that they would like to visit clients, but simply do not have enough staff. It is our strong impression that visiting clients can be a very powerful tool for overcoming information problems (and for selling bank products, which is another subject entirely).

Some banks try to improve their monitoring of clients by requiring that clients do a large percentage of their business with the bank. This "loyalty requirement" gives the bank more confidence that it knows what the client is up to, and can accurately assess the client's financial position. However, to demand such loyalty, a bank must offer all or at least the vast majority of the services a client needs. Loyalty, therefore, works best as a monitoring tool when the bank is able to offer a wide range of services. Very small banks have difficulty in following this strategy.

In evaluating banks' lending policies, it is important to be aware of the kinds of loans that Croatian banks provide. The majority of loans granted are short-term loans for liquidity or working capital purposes. Relatively few loans to businesses are long-term. However, if we examine the maturity of loans by their values in banks' balance sheets, the weight of long-term lending appears to be much greater. This is because the majority of long-term loans are rather large.

Table 10: Typical bank loans

	Number	% sample banks	% sample assets
Less than 6 months	23	48.9%	36.2%
6 to 12 months	12	25.6%	34.1%
1 to 2 years	3	6.4%	5.0%
More than 2 years	5	10.6%	6.1%
No answer	4	8.5%	19.6%
Less than 0.5 million HRK	21	44.7%	19.3%
0.5 to 1 million HRK	5	10.6%	5.5%
1 to 2 million HRK	6	12.8%	5.6%
Above 2 million HRK	2	4.3%	0.1%
No answer	13	27.6%	79.5%

Regarding long-term loans, there are still some banks in Croatia that simply do not offer this facility. Furthermore, a number of banks say that they only offer long-term loans with the help of special government programs. This indicates that the problem of long-term funding sources remains acute for many Croatian banks.

Table 11: Long-term loans

	Number	% sample banks	% sample assets
Do not offer at all	6	12.8%	3.4%
Offer	24	51.1%	77.5%
Only through HBOR	11	23.4%	8.9%
Only through local government	3	6.4%	2.5%
Only with foreign funding	3	6.4%	7.8%
No answer	0	0.0%	0.0%

Naturally, the larger banks do offer long-term loans, and the smaller banks are more likely not to offer such loans, or rely on help from HBOR or local governments. Nor is it surprising that credit lines from foreign banks are used by some Croatian banks to fund long-term loans. This last practice is entirely reasonable.

One of the key issues facing Croatian banks in recent years has been the use of collateral. Banks continue to require high levels of collateral, as the table below shows:

Table 12: Collateral to loan ratios

	Number	% sample banks	% sample assets
Less than twice the loan	9	19.2%	35.9%
Twice the loan	29	61.7%	38.5%
More than twice the loan	7	14.9%	25.1%
No answer	2	4.2%	0.5%

Some banks, including some larger banks, are requiring lower levels of collateral. Two banks even mentioned trying to reduce collateral levels towards the legal minimum of 1.2 to 1. However, the majority of banks continue to require collateral of at least twice the loan value. The effects of these requirements are clear: they make it more difficult for customers to get loans, and they make loans more expensive.

At the same time, it may in fact be the case that the value of the collateral is exaggerated. Many banks indicate that property assessors are mainly engineers who are more focused on the cost of construction of buildings than on their market value. For this reason, they consider assessed values to be substantially above the values realizable upon foreclosure, which would partially justify higher collateral to loan ratios.

In fact, some banks have founded their own property-assessment companies. They state that these companies often assess property at lower values than court assessors do. However, these banks claim that their property-assessment companies come much closer to estimating the actual foreclosure value of properties. This allows the bank to decrease its collateral to loan ratio, and increases the bank's confidence in the result of possible foreclosures.

A fundamental paradox haunts the use of collateral in Croatia. Banks require higher levels of collateral because they know that foreclosure is difficult to achieve. And banks require more collateral from clients that they consider greater credit risks. Furthermore, banks consider the quality and extent of collateral to be a major element in the lending decision. Certainly, taking "excess" collateral can help a bank cover the extra costs incurred from long waiting periods for court judgements. However, it is not clear what is accomplished by demanding higher collateral if foreclosure is expected to fail.

This paradox suggests that banks' complaints about the inefficacy of the foreclosure process and of the courts in general may be somewhat exaggerated. For if banks truly thought that the probability of foreclosure were zero, they would not use collateral at all and they certainly would not make it a criterion in lending decisions. We will return to this issue below.

Banks do offer loans without collateral. The most common such loan is to a highly valued client for a short period of time. For example, if a blue-chip firm needed a small amount of money for two weeks to meet a payment, many banks would be willing to lend without asking for collateral, especially if the company were already a client of the bank.

Table 13: Do you offer loans without collateral?

	Number	% sample banks	% sample assets
No	15	31.9%	15.4%
Yes	32	68.1%	84.6%
No answer	0	0.0%	0.0%

Bankers also use small loans without collateral to test new clients. In such cases, banks often limit the loan on the basis of the previous year's turnover or other indicators of borrowing capacity. Thus, while the general principle holds that loans should be secured by two independent repayment sources, there are important exceptions that bankers consider essential to their business.

Turning now to loans to households, we found that the techniques for consumer lending have become quite standardized. The main criteria for consumer lending include the income of the individual, the quality of the firm they work in, and documentation that the person is in fact regularly receiving his pay. While collateral and insurance vary depending on the type and amount of the loan, the use of co-debtors and guarantors is extremely common.

One interesting area where there has been some change is the use of credit scoring to facilitate loan processing. Banks use credit scoring to minimize processing costs (by facilitating automation), and to reduce subjective judgements and possible biases.[4] Credit scoring has proven most valuable in markets where high lending volume (in terms of number of loans, rather than amount per loan) is possible. Whereas our last survey found only 2 banks using credit scoring, the number has risen to 8 in this year's analysis.

Table 14: Banks using credit scoring for loans to households

	Number	% sample banks	% sample assets
No	25	53.2%	39.1%
Yes	8	17.0%	53.6%
For applicant's firm	5	10.6%	5.2%
No answer	9	19.2%	2.1%

The category "credit scoring of the applicant's firm" refers to banks that use a scoring system for the firm the applicant works in. This method is probably not a full credit scoring method, for it does not use demographic data and does not take into account the characteristics of the individual applicant. However, it is a step in the direction of making the processing of loans to households into a relative automatic and objective process. The most common use of credit scoring in Croatia today seems to be for credit card loans.

4 For a good explanation of how credit scoring can make loan processing more efficient, see Allen (1997).

In general, one of the challenges of lending to households is to keep processing costs down, since loans to households tend to be much smaller than loans to businesses. However, in Croatia, the profitability of lending to households relative to lending to businesses is especially good, because the default rate of households is substantially lower than the default rate of firms. Some bankers credit the co-debtor and guarantor system, which allows them to put moral pressure on a household that does not pay back promptly.

Table 15: Who is a better repayer of loans?

	Number	% sample banks	% sample assets
Firms	1	2.1%	0.3%
Households	36	76.6%	94.2%
It depends	4	8.5%	4.3%
No answer	6	12.8%	1.2%

A number of bankers did note slight deterioration in households' repayment performance. The consensus was, however, that this deterioration has been slight, and does not endanger households' relative superiority to firms.

Another issue we discussed with banks was the organization of the loan approval process. Here, much has changed since our last survey. Whereas, 2 years ago, very few banks had a risk assessment or quality control department that checked application before sending them on to a credit committee for decision making, this practice has become common:

Table 16: Banks with risk management or quality control

	Number	% sample banks	% sample assets
Do not have	19	40.4%	14.3%
Do have	27	57.5%	85.6%
No answer	1	2.1%	0.1%

As the asset figures show, the largest banks do have risk assessment or quality control departments. These departments are justified by the "four eyes" principle, which states that loans should not be granted unless at least two different sets of people have seen the loan application and signed off on it. Having a separate risk assessment may seem like a luxury for small banks, but it can be an important circuit breaker preventing damaging breakdowns of the lending process.

Also, two years ago, banks were approximately evenly split between those with Credit Committees and those whose management approved loans. Now Credit Committees predominate. This is in harmony with growing internal development of banks, and provides greater opportunities for getting different opinions on the credit process.

Table 17: Who approves loans?

	Number	% sample banks	% sample assets
Management	7	14.9%	9.0%
Credit Committee	40	85.1%	91.0%
No answer	0	0.0%	0.0%

A well-organized loan processing organization reaches decisions rapidly. Here, Croatia's small banks continue to excel, often approving loans in just a few days. Our question referred to a business loan to a completely new client.

Table 18: Time between application and loan approval

	Number	% sample banks	% sample assets
< 1 week	12	25.5%	7.4%
1 to 2 weeks	17	36.2%	16.6%
> 2 weeks	17	36.2%	75.6%
No answer	1	2.1%	0.4%

As could be expected, larger banks tend to process applications more slowly. This provides a source of competitive advantage to smaller banks. However, it should be noted that larger banks often work with larger clients, whose business is more complex and whose applications are harder to assess. Furthermore, larger banks are more likely to make longer-term loans, which are even more complicated.

As an aside to this discussion, bankers noted that one of the biggest sources of delay comes from the slowness of land registers. Since applicants must often submit proof that collateral is registered in the land register, slow registration can hold up the whole lending process substantially. Also, bankers noted that applicants themselves often take time to finish various elements of the application, so that some of the total delay between initiation of an application process and actual approval can be attributed to the clients' speed in completing the application.

5. The Courts

The failure of the court system to rapidly reach judgements on foreclosure and bankruptcy, and to enforce those judgements in a timely manner, has been one of the main problems facing banks as creditors in Croatia. We asked banks whether there has been any improvement in this regard in the last two years, and the answers were predictably discouraging.

Table 19: Have the courts improved in the last two years?

	Number	% sample banks	% sample assets
No	25	53.2%	49.4%
Worse	6	12.8%	11.1%
Better	6	12.8%	31.7%
No answer	10	21.2%	7.8%

Furthermore, a substantial minority of banks reports that they never have succeeded in foreclosing property.

Table 20: Have you ever succeeded in foreclosing property?

	Number	% sample banks	% sample assets
No	14	29.8%	29.8%
Yes	24	51.1%	47.8%
No answer	9	19.1%	22.4%

Finally, the banks were asked to estimate the time required for an average foreclosure.

Table 21: Average foreclosure time

	Number	% sample banks	% sample assets
Less than 6 months	1	2.1%	6.0%
6-12 months	5	10.6%	33.7%
1-2 years	5	10.6%	3.3%
More than 2 years	22	46.8%	50.5%
No answer	14	29.1%	6.5%

It is probably not necessary to say anything about the difficulties banks experience when foreclosure takes more than 2 years.

Bankers offered their opinions for the slowness of the courts. While there was some agreement that a pro-debtor culture still exists in many areas, some bankers felt that the biggest problem is judges' reluctance to actually make decisions. Existing procedure gives enormous room for delays, and judges seem willing to accept this. A few bankers also suggested that court personnel may be inadequately trained for their jobs.

We also asked whether banks noticed differences in the functioning of the courts in various regions of the country. The main pattern in the answers was that banks find it easier to initiate procedures in their home counties. Simply getting a case going is easier, apparently due to personal contacts. Also, banks indicate that both entrance into the land register and foreclosure cases go faster outside of Zagreb. However, a few banks did suggest that local courts are more likely to protect debtors than are the courts in Zagreb, especially when the case concerns an important local firm.

While it is not our intention to shift blame for banking problems to the courts, it remains true that banks' business is greatly affected by the performance of the courts. Without improvements in the legal arena, banking will continue to be severely handicapped in Croatia. Lending will be more expensive, as weak court performance is reflected in higher collateral requirements and in higher interest rates to offset the probability of failure to collect collateral.

A final question that we asked is whether the recent introduction of the instrument of fiduciary ownership has led to improvements. In particular, we asked whether banks prefer fiduciary ownership to the use of mortgages.

Table 22: Which is preferable, fiduciary ownership or a mortgage?

	Number	% sample banks	% sample assets
Fiduciary	29	61.7%	56.7%
Mortgage	4	8.5%	32.5%
It depends	7	14.9%	8.1%
No answer	7	14.9%	2.7%

The advantage of fiduciary ownership is that it can be activated quickly, without a court judgement, and is simpler. However, some bankers expressed the reservation that fiduciary ownership can be expensive. Also, bankers felt that fiduciary ownership might be easier to challenge in court. Furthermore, since experience with fiduciary ownership is limited, some banks are leery of it for that reason alone. Also, some banks point out that fiduciary ownership does not make sense for some kinds of loans, such as loans for repairs or modifications on an apartment. Finally, under both fiduciary ownership and mortgage contracts, the property would end up in the bankruptcy process if one were initiated.

6. Leasing and Forfaiting/Factoring

Leasing and forfaiting/factoring are two common financial products in more developed economies. Although the Banking Law explicitly allows both leasing and factoring or forfaiting (Article 36), both are relatively rare in Croatia.

Table 23: Banks offering leasing

	Number	% sample banks	% sample assets
Offer leasing of business equipment	4	8.5%	4.5%
Offer leasing of consumer goods	2	4.3%	2.9%

There are two types of problems preventing further growth of the leasing business. The first relates to the functioning of the legal system. Even though the laws would clearly support a bank seeking to repossess assets leased to a client who has failed to make lease payments, practice is less encouraging. Banks believe that, in practice, they face a substantial risk of being unable to regain their property.

The second problem relates to the tax and accounting system. Under current Croatian law, it is the lessor (the party that uses the asset) rather than the lessee (the bank) that gets the right to amortize the asset. This means that the tax deduction goes to the lessor. Furthermore, given provisions for rapid amortization, the bank may find that its claim on the lessor is greatly devalued in a short period of time, inhibiting longer leases.

These problems have inhibited the growth of leasing. Instead, banks used fiduciary ownership or even mortgage contracts, which are similar but not exactly the same. True leasing gives the lessor great flexibility, allowing him to minimize financial commitments. Also, the lessee may keep responsibility for certain services such as upkeep and maintenance. This has worked out well in the case of auto leasing, since the lessee ensures that the car, which it owns, stays in good condition, and earns profits on the upkeep and maintenance service. The lessor gets a "headache-free" lease in which he does not have to worry about upkeep and maintenance at all.

Given the popularity of leasing in more advanced financial markets, it would be worthwhile to study whether the obstacles to leasing in Croatia can be removed.

Forfaiting and factoring are also very common financial arrangements around the world. Both involve the purchase of claims by the bank at a discount. There are practical and legal problems inhibiting both of these arrangements, however. For one thing, both involve unsecured claims on an economic subject. Given the low liquidity and creditworthiness of many economic subjects in Croatia, domestic forfaiting or factoring is generally not attractive.

When it comes to forfaiting or factoring claims on foreign subjects, banks are faced with restrictions imposed by the Law on the Foreign Exchange System, Foreign Exchange Operations and Gold Transactions. The problem is that when enterprises sell foreign exchange claims on foreign subjects to banks, the enterprises are required to submit proof that they have invoiced their claims within 15 days. However, the sale of the claim to the bank is not considered an invoice, according to the Decision on the Conditions and Manner of Providing Documentation for Foreign Exchange Transactions.

Since these contracts are desired by enterprises (because they allow enterprises to receive their payment sooner) and by banks (because they allow banks to earn money on the discount offered), it is difficult to see why they should be prevented. The major risk is that the bank will not be repaid by the foreign subject. However, given banks' strong liquidity in foreign exchange, there is no obvious reason why they should be prevented from taking on such risk.

7. Plans for 2000

Banks were asked to select from a menu of options which changes they expected to implement in the year 2000.

Table 24: Changes for 2000

	Number	% sample banks	% sample assets
Lower interest rates on loans	24	51.1%	60.7%
Merge with a foreign bank	18	38.3%	45.4%
Offer new products	18	38.3%	21.9%
Do more business with households	16	34.0%	25.5%
Merge with another Croatian bank	14	29.8%	41.1%
Offer payment services	14	29.8%	24.2%
Lower fees	14	29.8%	21.3%
Increase advertising	12	25.5%	13.6%
Expand branch network	11	23.4%	25.6%
Offer new services	10	21.3%	19.9%
Open more bankruptcies	7	14.9%	15.7%
Offer electronic banking services	7	14.9%	7.2%
Do more business with firms	5	10.6%	3.5%
Offer faster services	3	6.4%	4.8%

The table suggests some interesting trends. First, the price of banking services, as reflected both in loan rates and fees, is likely to fall. This corresponds to recent trends and to the expected impact of the acquisition of major Croatian banks by powerful foreign banks.

Second, banks continue to look to the household sector as a source of expansion. This is reflected both in the answer "do more business with households" and in the answer "expand branch network." Firms, however, are quite out of favor.

Third, banks seem to be realizing that simply offering faster service is not adequate, and are finding ways to expand the kinds of products and services offered, including payments and electronic banking. It should be noted that 2000 will be the first year in which banks will be allowed to offer payments services, as the monopoly of the ZAP will finally be ended.

Fourth, there is substantial interest in mergers. The numbers suggest that smaller banks are more likely to prefer mergers with other Croatian banks. However, this may be misleading, since the banks expressing interest in merger with foreign banks include the three large banks in rehabilitation, whose owner, the State Agency for Bank Rehabilitation and Deposit Insurance, made the decision to find foreign majority owners for them. If these three banks are removed, we are left with 15 banks (31.9% of sample banks) with 13.8% of sample banking assets, that is, smaller banks.

8. On Small Banks and Large Banks

At the end of this survey, it may be useful to reflect a little bit on the state of the Croatian banking market. The key issues are the degree of competition, the degree of specialization, and future trends.

Despite the large number of banks in Croatia, competition remains limited. In many local areas, a single bank holds a dominant market share. It is still the case that only 2 banks are truly present on a national level, and even these two banks are actively trying to improve their ability to provide banking services throughout Croatia.

From this point of view, it is encouraging that three of the largest regional banks have recently come under the ownership of much larger foreign banks. All of these banks have expressed an interest in becoming national-level competitors. This should prove very beneficial for Croatian consumers, who should benefit from cheaper and better banking services.[5]

One may well ask, however, what about the regions? And what about smaller firms?

It is our belief that the demand for banking services is strong enough in all of the regions of Croatia to ensure that creditworthy clients will be able to receive the necessary services. If the big national banks do succeed in expanding their networks throughout the country, they will tend to take many of the better, larger firms, even at the regional level. Such larger firms will require a broader range of financial services than smaller local banks can provide. Also, the larger banks will probably be able to offer a more attractive menu of financial products for households, and are likely to end up with substantial shares of household deposits at the regional level as well.

At the same time, there is some reason to believe that large national banks are not as likely to find smaller businesses and craftspeople interesting. Berger, Kashyap and

5 Simons and Stavins (1998), for example, document how consumers enjoy higher deposit interest rates and lower fees in more competitive banking markets in the U.S. In a European context, Danthine et al (1999) argue strongly in favor of increased competition, insisting that the argument that normal competition policy should not be applied to banks must be abandoned.

Scalise (1995), studying the U.S. experience, found that banks with less than $100 million in assets devoted 9% of their portfolios to small business loans, while banks with more than $10 billion in assets devoted less than 2% of their portfolios to small business loans. This finding led the authors to worry that the bank merger wave would lead to financing problems for small business.[6] However, in a later study, Berger, Saunders, Scalise and Udell (1998) found that, in situations where large banks came to dominate the market, they increased their share of small business lending. In other words, big banks changed their behavior when confronted with a market opportunity.

If the U.S. experience is any guide, what may happen in Croatia is that the larger banks abandon small business lending to some extent, leaving this market niche open for smaller, regional-based banks. These banks have the local experience, relationships, information capital and personnel to evaluate such businesses and meet their banking needs. Also, small businesses tend to appreciate the less bureaucratic nature of small banks, and value highly small banks' ability to provide rapid service. Our interviews have further convinced us that there are a number of healthy, successful local banks, small in size both by international standards and even by Croatian standards, that are filling this market niche and are likely to continue to do so.

These observations contradict any simplistic notion that small banks are inferior to big ones. Small banks can succeed, but they will probably have to be specialized. There are market segments such as investment banking and retail banking that seem to have very large economies of scale, and probably are beyond the reach of small banks. But there are also segments such as small business lending that will continue to be attractive to smaller banks.

Can small banks survive on their own in the longer term? This is a difficult question to answer. The same question is being asked in the United States and the European Union, for example. So far, academic research suggests that scale economies in banking in general are not so great. In most banking services, research suggests that scale economies are exhausted somewhere in the range between US$100 to $600 million.[7] At current exchange rates, this would be between 800 million and 5 billion HRK—the range where most medium-sized Croatian banks are found.

Even these numbers do not exclude the possibility that small banks specialized in a particular market segment or product and/or in a particular region, may survive and be quite profitable. The somewhat bombastic predictions that Europe will soon have 3 banks are far from being fulfilled. Also, small banks' ability to survive may depend on their willingness to cooperate with each other and with the larger banks, whether to allow clients to obtain services that the smaller banks cannot offer themselves, to fund larger projects through syndicated loans or other cooperative arrangements, or to create necessary common infrastructure such as ATMs.

Another interesting issue is whether Croatian banks should aspire to becoming universal banks. There is a lively debate about whether investment banking and commercial banking are complementary. Canals (1997) argues that investment banking culture is very difficult to assimilate to a commercial bank, and also notes that risk can be concentrated in particular companies if a bank provides both commercial and investment banking services to those companies. By contrast, Danthine et al (1999) suggest that the complementarities generated by the common knowledge base of commercial and investment banks about a given company ultimately provide adequate synergies for universal banking. They also suggest that Europe will have room for only a few truly universal banks.

Certainly, Croatia, as a small country, would probably not have room for any true universal banks. At this point the investment banking activities of Croatian banks are rather limited, with IPOs and bond underwriting very limited. But expansion into Pension Funds and stockbrokerage is leading a few banks in the direction of becoming more universal. It should be noted that Croatian banks are doing this via separate companies (for example brokerage houses or leasing companies) within the bank's group, rather than through the bank itself. For the vast majority of Croatian banks, however, the legal right to become universal banks in practice is not likely to be of great significance.

In the future, then, we should expect to see a Croatian banking market with greater national competition, some more regionalized broad-service commercial banks, and local or specialized niche players. Such a development, which will have to be aided by a strong regulatory framework and rapid moves to remove state influence from the banking sector, should contribute to a substantial improvement in the price and quality of banking services.

6 For a more recent skeptical view, see Dymski (1999).

7 See Benston, Hanweck and Humphries (1982) and Noulas, Ray and Miller (1990) for key early studies of scale economies, and Rhoades (1998), Calomiris and Karceski (1997), Berger, Demsetz and Strahan (1998) and Piloff and Santomero (1997) for surveys of recent findings.

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Appendix 1: Weighting Scheme For Synthetic Index of Written Credit Policy

1. Risk diversification	
– regional goals	0.25
– sectoral goals	0.75
– currency structure goals	0.25
– term structure goals	0.25
2. Types of credit	0.50
3. Price of banking services	
– interest rates	0.25
– fees	0.25
4. Size limits	1.00
5. Documentation	1.00
6. Collateral	1.00
7. Decision criteria and authority	
– criteria	1.00
– authority	1.00
8. Contract contents and termination	
– contents	0.50
– termination	0.50
9. Follow-up	
– documenting client contacts	0.50
– following repayment	0.50
10. Repayment	
– procedures in case of non-payment	0.50
– prolongation conditions	0.50
11. Exceptions	1.00

Appendix 2: Problems with Forfaiting and Factoring

(by Hrvoje Dolenec)

Both forfaiting and factoring are explicitly permitted by the Banking Law (Article 36, first paragraph, point 7) for those banks with paid-in capital of 40 million kuna or more. We asked banks whether they engaged in these activities.

A forfaiting contract is the sale of non-matured monetary claim to a bank. The bank does not have the right to a claim on the seller if the claim sold proves impossible to collect. The claim is transferred by the ceding of the rights to the proceeds from a sale. The bank may freely dispose of the claim, since the original seller is no longer responsible for the collectability of the claim. Usually the claims are on the basis of bills of exchange. Forfaiting is done at a discount, and of course includes a premium for the risk of non-payment.

Factoring is a specific form of short-term financing based on the sale of short-term, generally uncollateralized assets of a firm to a specialized financial organization called a factor. Usually the assets are non-matured claims on a buyer, and, in less-developed financial markets, the factor is usually replaced by a bank. The factor buys claims for a fee. The payment risk may be borne either by the client or the factor. This determines the interest rate, risk premium and factors' fee. Factoring includes short-term, quickly repayable claims on the client's debtors. Usually there are many such claims. In addition to financing the firm's activities, factoring may have as a goal the service of obtaining payment or the transfer of credit risk from the client to the factor.

The majority of banks are interested in engaging in these activities. However, it is necessary to distinguish between domestic and foreign transactions. In domestic transactions, it is very difficult to find claims that satisfy banks' risk-return criteria. This is because forfaiting releases the seller from responsibility for assuring repayment of the claim, while factoring necessarily involves an unsecured claim. In an environment of inadequate protection of creditors and generally poor liquidity in the domestic economy, banks are very reluctant to embark on these activities.

However, banks are extremely interested in forfaiting and factoring involving claims on foreign entities. Their interest stems from the high rates of repayment expected, as well as the prospect of increasing foreign exchange assets and thereby offsetting the large amounts of foreign exchange liabilities in banks' balance sheets (75 percent of total deposits are foreign exchange deposits.) However, banks are unable to do this because of barriers contained in current legislation and they have repeatedly warned the Croatian National Bank and Ministry of Finance of the problem. Up to now, banks have managed to perform such activities by approving fictive kuna credits at the same time as writing contracts for the cession of the kuna equivalent of the foreign exchange proceeds due to the client. However, since cessions and assignations have been prohibited when giro accounts are blocked, this type of transaction has become almost impossible.

Where is the problem? According to Article 47 of the Law on the Foreign Exchange System, Foreign Exchange Operations and Gold Transactions, enterprises with foreign claims are required to realize their claims on the basis of exports of goods and services within 90 days (with an extra 60-day extension possible). This is appropriate for the export business and is attractive to banks. However, according to the Decision on the Conditions and Manner of Documenting Foreign Exchange Transactions, enterprises are required to report payment for the goods to the Croatian National Bank within 15 days of the expiration of the claim realization period. But when a firm sells its claim to a bank, it cannot document the payment to the Croatian National Bank. For this reason, the Decision must be amended to allow banks to perform these transactions without violating the law. A solution to this legal problem would allow banks to engage in an activity permitted by the Banking Law. It would also increase the range of products banks can offer to clients, and would improve clients' opportunities to obtain liquidity.

Appendix 3: Problems with Financial Leasing

(by Hrvoje Dolenec)

One of the questions in our survey was whether banks offer financial leasing. According to the Banking Law (Article 36, first paragraph, point 7) banks with at least 40 million kuna of paid-in capital may offer financial leasing.

Leasing is a specific arrangement involving the use of an asset such as equipment or real estate. The lessee (the user of the object) agrees to pay the lessor (the owner of the object) a series of payments during the lease period. Leasing is classified into operative and financial leasing. Financial leasing is a form of leasing contract in which the object of the lease remains in the hands of the lessee at the termination of the agreement. The lease is for a fixed period and may not be broken. The following are some variants of financial leasing:

1. The lease period and the usual useful life of the object of the lease are approximately equal. This in practice means that the lease period is usually at least 90% of the average useful life of the object.
2. The lease period is less than 40% of the average useful life of the object.
3. The lease period is between 40% and 90% of the average useful life of the object, and the lessee obtains the right to buy the object for a small payment at the end of the lease or to extend the lease.
4. The object is so specific that no third party can use it.

In theory, the owner of the object of the financial lease is the lessor, as in all forms of leasing. However, the ultimate aim of financial leasing is for the lessee to gain ownership over the object. Therefore, leasing is really a financial product that is in competition with loans, and a lease should be treated as a loan.

Despite this, when we examine the tax and accounting treatment of financing leasing, we find that these depend on the approach taken. In the "formal approach", the owner is the lessor, and he is responsible for tax obligations resulting from his purchase of the object and the lease of the object. He must treat the object as an asset in his books and amortize its value. At the same time, the lessee may treat lease payments as an expense, and must register his obligations to the lessor as liabilities. In the "substantive approach", the fact that leasing is designed to result in the eventual purchase of the object by the lessee is recognized. The lessee is treated as the owner of the object and must pay taxes related to the purchase of the object. He amortizes the object in his book, and counts lease payments as expenses, while the lessor is only obliged to book lease payments as income and to carry his claim on the lessee on his books as long as it exists.

Croatian banks mainly stated that they do not offer financial leasing. Small banks tended to say that they do not have the financial and human resources, as well as knowledge, required. Larger banks were more likely to emphasize the outstanding legal, tax, accounting and regulatory questions surrounding this product.

Legal framework

In Croatia, the Bankruptcy Law (Official Gazette, No. 44/96) and Law on Foreclosure (Official Gazette, No. 57/96) should allow the lessor to quickly and effectively seize the leased object if the lessee does not fulfill his contractual obligations. The institution of fiduciary ownership has an important role in this, since it avoids the need for court procedures and makes the process of seizure of the object of leasing simpler. However, the problem is not in the laws but in current practice, which shows that creditors have great trouble exercising their rights even though the law is on their side.

It should be mentioned that banks are limited in their investment in physical property by the Croatian National Bank regulations. Also, their main business is financial, not commercial, so that it is not in their interest to repossess large amounts of physical assets. This is especially true in the light of the thinness of secondary markets for the sale of such objects, which makes it difficult for banks to "cash in" such assets.

Tax framework

Croatian employs the "substantive approach" which allows the lessee to obtain a tax deduction for the amortization of the leased object. Also, since accelerated depreciation is permitted in Croatia, the lessee can gain a substantial tax break as well. Since banks as lessors do not receive any tax incentives, even though they are the legal owners of the leased objects, and banks must pay taxes on income from leasing, banks have no tax incentive to engage in leasing. Also, an object that is subject to accelerated depreciation rapidly loses its accounting value, and its market value is often hard to establish. This makes such an object difficult to use as collateral well before the end of the leasing agreement.

Accounting framework

Since Croatia uses the "substantive approach" here as well, lessor (bank) must classify the object of leasing as an off-balance sheet asset. At the same time, it registers a claim on its balance sheet similar to a loan claim, receives income based on contractual relations, and treats the leased object as collateral. The lessee carries the object of the lease on his balance sheet and amortizes it, and has an obligation to the bank that he services like a loan. The problem is the same as in the previous paragraph. The lessee amortizes the leased object, and may completely write it off before the end of the lease. This destroys the value of the bank's collateral. Also, in case of failure to honor the obligations in the lease, the bank must seize the asset, increasing its ratio of non-financial assets to capital and possibly leading to a violation of CNB regulations.

Regulatory framework

The leasing industry in Croatia is not separately regulated. But it would be useful for the Croatian National Bank to monitor financial leasing closely, since banks are allowed to engage in such activities, and since financial leasing is treated as a lending relationship.

In view of all of the problems that banks face in offering this important product, it would be advisable for the CNB to re-examine the regulatory framework for activities with a view to giving banks greater latitude in offering these services.

Appendix 4: Banks Interviewed

Alpe Jadran banka d.d.
Bank Austria Creditanstalt Croatia d.d.
Bjelovarska banka d.d.
BNP - Dresdner Bank (Croatia) d.d.
Brodsko-posavska banka d.d.
Centar banka d.d.
Cibalae banka d.d.
Convest banka d.d.
Credo banka d.d.
Croatia banka d.d.
Čakovečka banka d.d.
Dalmatinska banka d.d.
Dubrovačka banka d.d.
Gospodarsko kreditna banka d.d.
Hrvatska poštanska banka d.d.
Hypo Alpe-Adria Bank d.d.
Hypobanka d.d.
Imex banka d.d.
Istarska banka d.d.
Istarska kreditna banka Umag d.d.
Jadranska banka d.d.
Kaptol banka d.d.
Karlovačka banka d.d.
Krapinsko-zagorska banka d.d.
Kreditna banka Zagreb d.d.
Kvarner banka d.d.
Međimurska banka d.d.
Nava banka d.d.
Partner banka d.d.
Podravska banka d.d.
Požeška banka d.d.
Privredna banka Zagreb d.d.
Raiffeisenbank Austria d.d.
Riječka banka d.d.
Samoborska banka d.d.
Sisačka banka d.d.
Slatinska banka d.d.
Slavonska banka d.d.
Societe Generale d.d. Paris
Splitska banka d.d.
Štedbanka d.d.
Trgovačka banka d.d.
Cassa di Risparmio di Trieste – Banca d.d.
Varaždinska banka d.d.
Volksbank d.d.
Zagrebačka banka d.d.
Zagrebačka banka-Pomorska banka Split d.d.

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In its periodical publications *Working Papers, Surveys and Discussion Papers*, the Croatian National Bank publishes scientific and scholarly papers of the Bank's employees, visiting scholars, and other associate contributors.

After the submission, the manuscripts shall be subject to peer review and classification by the Manuscript Review and Classification Committee. The authors shall be informed of the acceptance or rejection of their manuscript for publication within two months following the manuscript submission.

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The first page of the manuscript should contain the article title, first and last name of the author and his/her academic degree, name of the institution with which the author is associated, author's co-workers, and the complete mailing address of the corresponding author to whom a copy of the manuscript with requests for corrections shall be sent.

Additional information, such as acknowledgments, may be included in the first page. If this information is extensive, it is preferred to incorporate it within the text, whether at the end of the introductory section or in the special section preceding the list of references.

The second page should contain the abstract and the key words. The abstract is required to be explicit, descriptive, written in third person, consisting of not more than 250 words (maximum 1500 characters). The abstract should be followed by maximum 5 key words.

A single line spacing and A4 paper size should be used. The text must not be formatted, apart from applying bold and italic script to certain parts of the text. Titles must be numerated and separated from the text by a double line spacing, without formatting.

Tables, figures and charts that are a constituent part of the paper must be well laid out, containing: number, title, units of measurement, legend, data source, and footnotes. The footnotes referring to tables, figures and charts should be indicated by lower-case letters (a,b,c…) placed right below. When the tables, figures and charts are subsequently submitted, it is necessary to mark the places in the text where they should be inserted. They should be numbered in the same sequence as in the text and should be referred to in accordance with that numeration. If the tables and charts were previously inserted in the text from other programs (Excel, Lotus…), these databases in the Excel format should also be submitted (charts must contain the corresponding data series).

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Formulae must be legible. Indices and superscript must be explicable. The symbols' meaning must be given following the equation where they are used for the first time. The equations in the text referred to by the author should be marked by a serial number in brackets closer to the right margin.

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