

Pursuant to Article 101, paragraph (2), item (2) of the Credit Institutions Act (OG 159/2013) and Article 43, paragraph (2) item (9) and Article 77 of the Act on the Croatian National Bank (OG 75/2008 and 54/2013), the Governor of the Croatian National Bank hereby issues the

**Decision**  
**on the classification of placements and off-balance sheet liabilities of credit institutions**

**1 GENERAL PROVISIONS**

**Subject matter**  
**Article 1**

This Decision prescribes:

- 1) the criteria for the classification of placements and off-balance sheet liabilities on the basis of which a credit institution is exposed to credit risk,
- 2) the method of determining losses arising from credit risk,
- 3) the method of determining value adjustments, impairment of on-balance sheet items and provisions for off-balance sheet items,
- 4) rating of instruments of collateral for receivables, and
- 5) keeping of credit records.

**Legal persons subject to the application of the Decision**  
**Article 2**

- (1) Credit institutions with registered offices in the Republic of Croatia, authorised by the Croatian National Bank, shall be obliged to apply the provisions of this Decision.
- (2) Branches of credit institutions from third countries, authorised by the Croatian National Bank to provide services, shall also be obliged to apply the provisions of this Decision *mutatis mutandis*.

**Definitions**  
**Article 3**

The individual terms used in this Decision shall have the following meaning:

- 1) '**Placements**' means financial assets in a form of granted loans, debt instruments and other receivables, classified by a credit institution into categories of financial instruments, in accordance with its business policies, which are, according to the International Accounting Standard 39 Financial Instruments: Recognition and Measurement (hereinafter: IAS 39), designated as – "loans and receivables" and

– "held-to-maturity investments".

Placements shall also encompass principal and interest income in its entirety, relating to an individual financial instrument, which includes receivables based on interest and all receivables based on commissions and fees included in the calculation of the effective interest rate. Principal is a placement or a part of a placement which does not constitute the income of a credit institution.

Receivables based on commissions and fees which do not constitute a part of the total interest income relating to a particular placement shall be deemed a separate placement.

2) '**Individually significant exposure**' means the overall exposure of a credit institution to a single person or to a group of connected persons, which does not exceed the amount determined by Article 9 of this Decision. For the purpose of this Decision, the exposure amount includes all on-balance and off-balance sheet asset items that are subject to classification into risk categories in accordance with the provisions of this Decision.

3) '**Portfolio of small loans**' means the overall exposure of a credit institution to a single person or to a group of connected persons (on the basis of all the exposures referred to in item (2) of this Article) which does not exceed the amount determined by Article 9 of this Decision.

4) '**Individual credit risk assessment**' means an individual assessment of future cash flows and determining the existence or non-existence of losses on each individual placement and individual off-balance sheet liability, which a credit institution is obliged to apply when assessing placements and off-balance sheet liabilities constituting an integral part of individually significant exposure, i.e. which a credit institution may also apply when assessing exposures from the portfolio of small loans.

5) '**Collective credit risk assessment**' means a collective assessment of future cash flows and determining the existence or non-existence of losses on several similar placements, i.e. off-balance sheet liabilities, which is performed in the following cases:

- when assessing quality of placements, i.e. off-balance sheet liabilities, where no evidence is identified of the existence of evident losses, but where latent losses may exist, which are collectively assessed on the basis of historical loss experience (this assessment includes all placements, i.e. off-balance sheet liabilities, classified into risk category A), and
- when assessing identified losses on placements classified under "portfolio of small loans", unless these placements are assessed individually.

6) '**Value adjustment of placements**' means the amount of identified losses on placements for which evidence of impairment loss exists (placements classified into risk categories B and C), as well as the amount of loss on placements for which there is no evidence of impairment loss when assessed individually, but for which an assessment has been made, on the basis of historical loss experience, that latent losses exist in the portfolio of placements classified into risk category A.

7) '**Assumed off-balance sheet liabilities**' means traditional off-balance sheet risky items, i.e. liabilities (which do not include the contractual value of derivative instruments), the settling of which requires or might require an outflow of credit institution's cash, on the basis of which, due to

uncollectibility of the future outflow of credit institution's funds, the credit institution is exposed to credit risk (issued guarantees, opened uncovered letters of credit, letters of guarantee, commitments under credit contracts, etc.).

8) '**Provision for off-balance sheet liabilities**' means the amount of assessed losses due to uncollectibility of the future outflow of credit institution's funds, for the purpose of settling the assumed off-balance sheet liabilities.

9) '**Placement restructuring**' means a change in the originally contracted terms of crediting due to a deterioration in any of the general classification criteria referred to in Article 5, paragraph (1) of this Decision. A placement is deemed restructured if the interest rate is reduced, if interest income is reduced or written off, if the amount of principal is changed, if repayment periods are modified, if a new placement is directly or indirectly granted in exchange for the existing one and/or if other originally contracted terms of crediting are changed. Placement restructuring which results in a reduction of the originally contracted liabilities of a debtor shall be deemed evidence of loss.

10) '**Refinancing**' means a change in the originally contracted terms of crediting which is not due to a deterioration in any of the general classification criteria referred to in Article 5, paragraph (1) of this Decision, but which results from regular operations in accordance with the credit institution's credit policies. Refinancing shall also be the granting of a new in placement in exchange for the existing one, in response to the usual current needs for financing a debtor's business activities.

11) '**Eligible instruments of collateral**' means instruments of collateral taken into account by a credit institution in the assessment of future cash flows. The eligible instruments of collateral are divided into first-class instruments, appropriate instruments of collateral in a form real estate or movable property and other appropriate instruments of collateral. In order to be considered eligible, an instrument of collateral must meet the conditions referred to in Article 36, 37 or 38 of this Decision.

12) '**Impairment factor**' means a factor used for the value adjustment of estimated future cash flows arising from an instrument of collateral in relation to the market price of the instrument of collateral and the appropriate internally estimated collection period.

## **2 CLASSIFICATION OF PLACEMENTS INTO RISK CATEGORIES**

### **2.1 SUBJECT OF CLASSIFICATION**

#### **Placements classified into risk categories**

##### **Article 4**

(1) A credit institution shall classify placements, which are in accordance with IAS 39 classified into the following categories, into the appropriate risk categories by a degree of credit risk:

- 1) loan and receivables, and
- 2) held-to-maturity investments.

(2) Placements referred to in paragraph (1) of this Article shall include all balance sheet assets items on the basis of which a credit institution is exposed to a credit risk and which may be allocated to an individual debtor, as follows:

- 1) loans granted by a credit institution, including receivables arising from any payments made under uncovered letters of credit, guarantees and other commitments,
- 2) deposits with credit institutions, including deposits with the Croatian National Bank,
- 3) receivables based on financial leasing and factoring and forfeiting,
- 4) investments in debt securities,
- 5) receivables based on interest and non-interest income,
- 6) advance payments, and
- 7) other receivables on the basis of which a credit institution may be exposed to a credit risk due to a counterparty's default.

(3) Placements subject to the application of this Decision shall not include financial assets classified by a credit institution into the following categories, in accordance with IAS 39:

- 1) evaluated on a fair value basis through profit or loss, and
- 2) available-for-sale financial assets.

## **2.2 CRITERIA FOR PLACEMENT CLASSIFICATION ACCORDING TO A DEGREE OF CREDIT RISK**

### **General classification criteria**

#### **Article 5**

(1) A credit institution shall, in the entire period of contractual relationship, assess placement quality and shall classify placements into the appropriate risk categories on the basis of the following criteria:

- 1) debtors' creditworthiness,
- 2) debtors' timeliness in meeting their obligations towards a credit institution and other creditors, and
- 3) quality of instruments of collateral for credit institution's receivables.

(2) In accordance with best practice for credit risk management, a credit institution shall take into account, in classification placements, all the three criteria referred to in paragraph (1) of this Article.

(3) By way of derogation from paragraph (2) of this Article, a credit institution may base its classification, i.e. assessment of the quality of placements constituting an integral part of exposure to a single person which does not exceed the amounts referred to in Article 9 of this Decision, and for which identified losses are collectively assessed on only one or two criteria referred to in paragraph (1) of this Article. In this respect, it is mandatory to apply the 'timeliness' criterion referred to in paragraph (1), item (2) of this Article.

(4) Where the credit portfolio of a credit institution also contains placements in the approval of which not the borrower's creditworthiness but the quality and value of collateral were the main criteria, and for which the credit risk assessment is carried out individually, the credit institution shall, during the credit relationship, assess the quality of these placements on the basis of the results of monitoring the value and liquidity of the respective instrument of collateral, as well as the debtors' timeliness in meeting their obligations.

(5) Where the credit portfolio of a credit institution also contains placements which are not secured by eligible instruments of collateral and for which the credit risk assessment is carried out individually, the credit institution shall, during the credit relationship, assess the quality of these placements on the basis of debtors' creditworthiness and the timeliness in meeting the debtors' obligations.

### **Debtors' creditworthiness**

#### **Article 6**

(1) A credit institution shall assess debtors' creditworthiness at least on the basis of the following criteria:

- 1) debtor's status, personal and economic characteristics, as well as expertise of management and senior management (for legal persons), quality of plans and programmes financially supported by a credit institution,
- 2) debtor's level of capital and reserves and their share in debtor's balance sheet (for legal persons),
- 3) debtor's asset strength,
- 4) debtor's liquidity and profitability (for legal persons),
- 5) debtor's cash flows in the previous period and the expected future cash flows, relative to his/her liabilities,
- 6) business conditions and future prospects of a debtor, as well as debtor's position on the market and the position of the entire industry in which a debtor is engaged, and
- 7) debtor's exposure to currency risk arising from placements indexed to foreign currency and placements denominated in foreign currency, including off-balance sheet liabilities indexed to foreign currency and off-balance sheet liabilities denominated in foreign currency.

(2) Credit risk arising from placements referred to in paragraph (1), item (7) of this Article and the risk management techniques shall be viewed by the credit institution from the aspect of a possible change of the debtor's financial position which could take place due to a change in the exchange rate of the domestic currency against foreign currencies, i.e. from the aspect of debtors' ability to meet their credit liabilities towards a credit institution, in accordance with the contract, even in potentially changed circumstances.

(3) For the purpose of paragraph (2) of this Article, a credit institution shall establish an internal system of monitoring, analysing and assessing whether the foreign exchange position of an individual debtor or peer groups of debtors is matched and whether their cash flows can be adjusted to the potential changes in the level of their liabilities towards a credit institution and overall liabilities due to the effect of changes in the exchange rate. A credit institution shall award a particular attention to debtors with a mismatched position (with a short open foreign exchange position), as a result of which, in the case of a change in the exchange rate of the domestic currency

against foreign currencies (including off-balance sheet liabilities), major disturbances could occur in settling liabilities of these debtors towards a credit institution. It shall be deemed that the foreign exchange position of a credit institution's debtors is not matched if their foreign exchange inflow covers less than 80 percent of their foreign exchange liabilities and liabilities indexed to foreign currency, which they have towards the credit institution and other creditors. A credit institution shall develop an internal system of identifying debtors with matched and mismatched foreign exchange position.

(4) Exceptionally, paragraphs (2) and (3) of this Article shall not apply to placements indexed to foreign currency and foreign exchange placements which include off-balance sheet liabilities denominated in foreign currency, provided that the overall exposure, on the basis of this paragraph, to a single natural person and to a single legal person does not exceed HRK 50 000 and HRK 500 000, respectively.

### **Timeliness in meeting obligations**

#### **Article 7**

(1) Debtors' timeliness in meeting their obligations shall imply their capability to fully meet their obligations to a credit institution on the basis of placements in the contractual amounts and within the contractual time limits and only exceptionally and occasionally, after the due date, on the condition that the debtor's default is no more than 90 days and that the amount of debt in default is not material, i.e. that it does not exceed the amount referred to in Article 18, paragraph (9) of this Decision.

(2) For the purpose of paragraph (1) of this Article, debtors' timeliness in meeting their obligations shall not be deemed to exist in the case of placement restructuring.

### **Collateral quality**

#### **Article 8**

A credit institution shall, in the assessment of the quality of instruments of collateral, verify whether an instrument of collateral meets the conditions referred to in Article 36, 37 or 38 of this Decision.

## **2.3 INDIVIDUALLY SIGNIFICANT EXPOSURE**

### **Individually significant exposure**

#### **Article 9**

(1) Individually significant exposure shall be the overall exposure of a credit institution to a single person or to a group of connected persons, exceeding the following amounts:

- 1) HRK 500 000 if total assets of a credit institution amount to less than HRK 5bn,
- 2) HRK 1 000 000 if total assets of a credit institution amount from HRK 5 to 20bn, or
- 3) HRK 1 500 000 if total assets of a credit institution amount to more than HRK 20bn.

(2) The exposure referred to in paragraph (1) of this Article shall include the total amount of all on-balance sheet and off-balance sheet assets items, classified into risk categories, in accordance with the provisions of this Decision and which are reported in gross amount, i.e. without impairments of balance sheet assets items and provisions for off-balance sheet items.

(3) The assets referred to in paragraph (1) of this Article shall be the assets amount reported in audited financial reports of a credit institution for the previous year.

(4) Notwithstanding paragraph (1) of this Article, a credit institution may determine, by its internal by-law, a smaller amount of overall exposure to a single person as a threshold above which an exposure is considered individually significant.

(5) A credit institution shall apply the criteria determined by paragraph (1) or (4) of this Article consistently to all its debtors.

### **Credit risk assessment for individually significant exposure**

#### **Article 10**

(1) A credit institution shall assess individually, on the basis of the general classification criteria referred to in Article 5 of this Decision, credit risk, i.e. losses on placements to debtors who are persons or groups of connected persons to whom overall credit exposure of a credit institution exceeds the amounts referred to in Article 9 of this Decision.

(2) An individual assessment of credit risk, i.e. loss, shall imply the assessment of future cash flows and identification of existence or non-existence of losses for each placement that is a part of individually significant exposure, unless otherwise provided for by the provisions of this Decision.

## **2.4 EXPOSURE THAT IS NOT INDIVIDUALLY SIGNIFICANT**

### **Portfolio of small loans**

#### **Article 11**

For the purpose of this Decision, exposure of a credit institution to a single person or to a group of connected persons shall not be considered individually significant if it does not exceed the amounts referred to in Article 9 of this Decision (portfolio of small loans).

### **Assessment of credit risk for portfolio of small loans**

#### **Article 12**

(1) A credit institution shall assess individually credit risk, i.e. losses on placements constituting an integral part of portfolio of small loans, for each placement or for several placements that belong to that portfolio.

(2) Provided that credit risk, i.e. losses on placements constituting a portfolio of small loans, are assessed individually, a credit institution shall act in a manner referred to in Article 10 of this Decision.

(3) Provided that a credit institution assesses credit risk, i.e. losses on placements constituting a portfolio of small loans, for several placements together, it shall perform the assessment of future cash flows and identification of existence or non-existence of losses together for several placements with similar characteristics (it shall form peer groups within the portfolio of small loans).

## **2.5 PLACEMENTS ACCORDING TO A DEGREE OF RISK (RISK CATEGORIES)**

### **General classification of placements by credit quality**

#### **Article 13**

(1) Depending on the possibilities of collection, i.e. on estimated future cash flows, all placements are classified into three broad categories (regardless of whether exposures are individually significant or they belong to a portfolio of small loans), as follows:

- 1) placements for which no objective evidence of impairment has been identified on an individual basis (risk category A),
- 2) placements for which objective evidence of partial impairment has been identified, i.e. partly recoverable placements (risk category B, consisting of risk sub-categories B-1, B-2 and B-3), and
- 3) placements for which objective evidence of full impairment has been identified, i.e. fully irrecoverable placements (risk category C).

(2) A credit institution shall perform assessment of credit risk and future cash flows or identification of existence or non-existence of losses on placements, referred to in paragraph (1) of this Article, in accordance with the provisions of Articles 14 to 24 of this Decision.

(3) A credit institution shall, in the case of placements granted in accordance with Article 5, paragraphs (4) and (5) of this Decision and in the case of placement restructuring, establish special records and an ex-post monitoring system.

### **2.5.1 PLACEMENTS FOR WHICH NO OBJECTIVE EVIDENCE OF IMPAIRMENT IS IDENTIFIED (RISK CATEGORY A)**

#### **Criteria for classification into risk category A**

#### **Article 14**

(1) A credit institution shall initially, at the beginning of a contractual relationship, classify the granted placements into risk category A.

(2) Placements for which no objective evidence of impairment has been identified shall be classified into risk category A, if all of the following conditions are met:

- 1) the present financial position of a debtor and the estimated future cash flows do not threaten his future operation and settling of current and future liabilities towards a credit institution and other creditors,
- 2) the debtor settles his/her liabilities towards a credit institution within the contractual time limits, and only exceptionally and occasionally, after the due date, and
- 3) placements are secured by eligible instruments of collateral for receivables of a credit institution, referred to in Articles 36 to 38 of this Decision.

(3) A credit institution may classify placements granted in accordance with Article 5, paragraph (5) of this Decision into risk category A if both of the following conditions are met:

- 1) the creditworthiness of a debtor permanently meets the applicable criteria pursuant to which a particular placement has been granted, taking into account the criteria referred to in Article 6, paragraph (1) of this Decision, and
- 2) the debtor settles his/her liabilities towards a credit institution within the contractual time limits, and only exceptionally and occasionally after the due date.

(4) A credit institution may classify placements granted in accordance with Article 5, paragraph (4) of this Decision into risk category A if both of the following conditions are met:

- 1) the debtor settles his/her liabilities towards a credit institution within the contractual time limits, and only exceptionally and occasionally after the due date, and
- 2) placements are secured by eligible instruments of collateral for receivables of a credit institution.

(5) A credit institution may classify into risk category A placements constituting an integral part of exposure to a single person which does not exceed the amounts referred to in Article 9 of this Decision, and for which identified losses are collectively assessed, only provided that the debtor settles his/her liabilities towards the credit institution within the contractual time limits.

#### **Subsequent individual assessment of placements classified into risk category A** **Article 15**

(1) During the period of contractual relationship, a credit institution shall perform on a regular basis, and at least every three months, subsequent assessment of the quality of placements that were classified into risk category A. If it has been established by the subsequent assessment that future cash flows will not be sufficient for settling the contractual amount of individual placements, regardless of whether these placements constitute an integral part of individually significant exposure or they belong to a portfolio of small loans, a credit institution shall reclassify these placements into category of partly recoverable or fully irrecoverable placements (into risk sub-category B-1 or worse).

(2) Subsequent assessment of the quality of placements constituting an integral part of individually significant exposure shall be performed by a credit institution in accordance with Article 10 of this Decision, and subsequent assessment of the quality of placements constituting a portfolio of small loans, in accordance with Article 12 of this Decision.

(3) Placements graded A, for which no evidence of impairment is identified at subsequent assessment and for which it is established, on the basis of the assessment of the future cash flows, that no impairment on individual basis is required, regardless of whether these placements constitute an integral part of individually significant exposure or they belong to a portfolio of small loans, shall remain in the risk category A until the following assessment. Placements of this category shall be collectively assessed by a credit institution for credit risk and for impairment, in accordance with Articles 16 and 17 of this Decision.

(4) By way of derogation from paragraph (3) of this Article, in the event of a debtor's delinquency, where the estimate of future cash flows is based on the value of the eligible instruments of collateral, and if a credit institution fails to take the required legal actions for the collection of its receivables by calling on instruments of collateral, it shall classify the placements into risk sub-category B-1 or worse and shall make a hundred-percent value adjustment of receivables based on interest income with respect to these placements and the appropriate value adjustment in the amount of at least 10% of receivables based on the placement principal. Should a credit institution fail to take the required legal actions for the collection of its receivables by calling on eligible instruments of collateral within a year from the occurrence of a debtor's delinquency, it shall make a value adjustment in the amount of at least 20% of receivables based on the placement principal.

(5) Regardless of the legal actions taken for the collection of a credit institution's receivables by calling on instruments of collateral, if the collection was not completed within two years from the date of occurrence of the debtor's delinquency, the credit institution shall classify the uncollected placements until their collection into risk sub-category B-1 or worse and shall, taking into account the remaining prospects for collection, make a hundred-percent value adjustment of receivables based on interest income and a value adjustment in the amount of at least 30% of receivables based on the placement principal, and shall increase it by 5% of receivables based on the placement principal after each additional 180-day-period.

(6) In the cases referred to in paragraphs (4) and (5) of this Article, delinquency is deemed to exist if a debtor has overdue liabilities to a credit institution, which are considered materially significant in accordance with Article 18, paragraph (9) of this Decision, for more than 90 days.

(7) A credit institution shall carry out the minimum value adjustments referred to in paragraphs (4) and (5) of this Article, regardless of the present value of estimated future cash flows arising from the collection of instruments of collateral. Where the loss on placements secured by eligible instruments of collateral, calculated in accordance with Article 19, paragraphs (2) and (6) of this Decision, exceeds the loss arising from paragraphs (4) and (5) of this Article, a credit institution shall make an appropriate value adjustment calculated in accordance with Article 19 of this Decision.

(8) The provisions of paragraphs (4) and (5) of this Article shall also relate to placements constituting an integral part of an individually significant exposure and to those belonging to a portfolio of small loans, when assessed individually.

#### **Subsequent collective assessment of placements classified into risk category A**

## **Article 16**

(1) For the purpose of a collective assessment of credit risk and collective impairment of placements, a credit institution shall classify placements graded A into appropriate categories which correspond to the balance sheet positions where the balance of these placements is reported.

(2) Within categories referred to in paragraph (1) of this Article, placements are further grouped by similar credit risk characteristics. This classification may be performed according to the purpose of placement, economic activity, geographic area, institutional sector of a debtor (corporates, credit institutions, financial institutions, government, households), type of collateral, risk weights that are assigned to individual placements in accordance with Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ, L 176, 27. 6. 2013, hereinafter: Regulation (EU) No 575/2013) and Decision implementing the part of Regulation (EU) No 575/2013 pertaining to the valuation of assets and off-balance sheet items and the calculation of own funds and capital requirements (hereinafter: Decision implementing Regulation (EU) No 575/2013), etc.

(3) Losses that are collectively assessed shall imply losses for which there is no evidence on the basis of which a direct relation could be made to individual placements constituting an integral part of individually significant exposure, i.e. to a peer group of placements constituting a portfolio of small loans, but for which it may be assessed, on the basis of historical loss experience, that they exist as latent losses in credit portfolio.

(4) A credit institution may consider the following as the data indicating that unfavourable changes have occurred in the course of contractual relationship which may contribute to a reduction of the future cash flows of a certain category of placements that may be measured, although they cannot be directly related to individual placements:

- 1) changes as regards payment ability of a debtor within an individual group (e.g. increased number of delayed payments, increased number of debtors settling their liabilities by a credit card or those who have reached their credit limit and are repaying only the minimum monthly amount), and
- 2) economic conditions, at the government or local level, related to a failure of a certain group of debtors to settle their liabilities (e.g. increased unemployment rate in a geographic area of a debtor, fall in prices of real estates provided as collateral or those on which there is fiduciary transfer of ownership and other unfavourable changes affecting the payment ability of a debtor).

(5) A credit institution shall perform a collective assessment of impairment losses on placements graded A in accordance with Article 17 of this Decision, taking into account the provisions of IAS 39, relating to impairment losses and uncollectibility of financial assets carried at amortised cost.

## **Collective impairment of placements classified into risk category A**

### **Article 17**

(1) A credit institution may perform the collective impairment of placements classified into risk category A in the amount of latent losses established by the credit institution by applying its internal

experience-based methodology prepared and tested in advance, where the level of the value adjustment may not be lower than 0.80% of the total balance of placements graded A.

(2) A credit institution having no internal methodology shall maintain the level of value adjustments of placements graded A on a collective basis to a minimum of 1% of the total balance of placements graded A.

(3) The impairment (value adjustment) of placements graded A shall be accounted for by debiting expenses of a credit institution for the period when the losses are identified and by crediting the corresponding value adjustment accounts of placements which are the subject matter of classification under this Decision.

(4) The credit institution referred to in paragraph (1) of this Article shall, at least once a year, review its internal credit risk assessment methodology and shall revise it, where necessary, for the purpose of reducing the differences between the estimated and actual latent losses that exist in the credit portfolio graded A.

## **2.5.2 PARTLY RECOVERABLE PLACEMENTS (RISK CATEGORY B)**

### **Evidence of existence of losses and impairment of placements**

#### **Article 18**

(1) Evidence of existence of losses arising from credit risk shall imply data on one or more events adversely affecting the debtor's ability to settle its liabilities towards a credit institution and other creditors in a timely manner. These events have occurred between the date of initial recognition of a placement and the date of subsequent assessment of the future cash flows arising from these placements. A credit institution shall account for losses as a result of past events by debiting expenses of the current period. Losses expected as a result of future events, no matter how likely, shall not be recognised as an expense of impairment of placements in the current period. A credit institution may form the appropriate reserves for covering these losses by distributing profit of the current period.

(2) Evidence of loss, in terms of paragraph (1) of this Article, relating to placements constituting individually significant exposures or a peer group of placements that belong to a portfolio of small loans, shall include in particular:

- 1) observable significant financial difficulties of a debtor,
- 2) a breach of contract, such as a default or delinquency in interest and/or principal payments or failure to perform other provisions of the contract,
- 3) restructuring of placements, which results in a reduction of the originally contracted liabilities of a debtor, and
- 4) existence of a probability of initiation of bankruptcy proceedings or taking of another legal action (financial reorganisation) as a result of a debtor's poor financial position.

(3) Loss on partly recoverable placements which are not secured by eligible instruments of collateral and for which the credit risk assessment is carried out individually shall be determined as a positive difference between the gross carrying amount of an individual placement and the present value of estimated future cash flows, discounted by applying the effective interest rate referred to in Article 20 of this Decision. The credit institution shall make an appropriate value adjustment of the placements which are not secured by eligible instruments of collateral and shall classify those placements into an appropriate risk category in accordance with Article 19, paragraphs (3) to (7) of this Decision.

(4) In the event of a debtor's delinquency, it shall not be considered that there is evidence of loss relating to placements referred to in paragraph (3) of this Article if debtor's cash flows can be reliably assessed and ensure full recoverability of placements.

(5) In the event of a debtor's delinquency, it shall be considered that there is evidence of loss relating to placements referred to in paragraph (3) of this Article if debtor's cash flows cannot be reliably assessed. In that case, the credit institution shall make an appropriate value adjustment of the placements which are not secured by eligible instruments of collateral and shall classify those placements into an appropriate risk category as follows:

- 1) if the debtor has overdue liabilities for more than 90 to 180 days, the credit institution shall make an appropriate value adjustment in the amount of at least 1%, but no more than 30% of receivables based on an individual placement's principal and shall classify the placement into risk sub-category B-1,
- 2) if the debtor has overdue liabilities for more than 180 to 270 days, the credit institution shall make an appropriate value adjustment in the amount of over 30%, but no more than 70% of receivables based on an individual placement's principal and shall classify the placement into risk sub-category B-2,
- 3) if the debtor has overdue liabilities for more than 270 to 365 days, the credit institution shall make an appropriate value adjustment in the amount of more than 70%, but less than 100% of receivables based on an individual placement's principal and shall classify the placement into risk sub-category B-3,
- 4) if the debtor has overdue liabilities for more than 365 days, the credit institution shall make a hundred-percent value adjustment of receivables based on an individual placement's principal and shall classify the placement into risk category C, and
- 5) if the debtor has overdue liabilities for more than 90 days, the credit institution shall make a hundred-percent value adjustment of receivables based on interest income.

(6) When assessing loss on placements that belong to a portfolio of small loans referred to in Article 5, paragraph (3) of this Decision, a credit institution shall apply the criteria referred to in paragraph (5) of this Article.

(7) A credit institution shall identify loss based on non-interest income exclusively on the basis of the criterion of debtors' timeliness in meeting their obligations to the credit institution, and shall make a hundred-percent value adjustment if the debtor is delinquent in meeting these obligations for more than 90 days, regardless of their material significance.

(8) In the cases referred to in paragraphs (4) and (5) of this Article, delinquency is deemed to exist if a debtor has overdue liabilities to a credit institution, which are considered materially significant in accordance with paragraph (9) of this Article, for more than 90 days.

(9) In the cases referred to in paragraph (5) of this Article, counting the days of delinquency starts with the day when the total amount of all of the debtor's overdue liabilities (where the contractual maturity date has expired), arising from all contractual relationships has become materially significant, i.e. larger than HRK 1,750.

(10) A credit institution shall classify into risk category C any placement not secured by an eligible instrument of collateral, where delinquency of a debtor in settling liabilities to a credit institution lasts for more than 365 days, counting from the maturity date, and where the overdue amount is not materially significant, i.e. it is below HRK 1,750, and shall make a hundred-percent value adjustment of that placement.

(11) A credit institution may, by an internal by-law, prescribe a more stringent (lower) material significance criterion for all placements or particular types of placements than that laid down in paragraph (9) of this Article, provided that the more stringent material significance criterion prescribed by an internal by-law is consistently applied and that it is appropriate to the type, characteristics and amount of the placement concerned.

(12) The Croatian National Bank may, in the supervision process, order a credit institution to adjust the material significance criterion to the type, characteristics and amount of a placement.

(13) The provisions of paragraphs (9), (10) and (11) of this Article shall apply *mutatis mutandis* to unauthorized citizens' current account overdrafts. In the case of an overdraft over a granted credit line, the amount of the unauthorised overdraft, together with the amount of the granted credit limit, should be deemed a past due liability of the debtor.

(14) Where a credit institution, based on a deterioration in a debtor's creditworthiness, establishes a loss heavier than that arising from paragraph (5) of this Article, it shall make a value adjustment in the amount of that heavier loss.

### **Partly recoverable placements**

#### **Article 19**

(1) Partly recoverable placements shall be the placements, for which, due to a debtor's deteriorated creditworthiness, delinquency in settling liabilities to a credit institution and an inadequate value of eligible instruments of collateral, it is assessed that it will not be possible to collect the principal and interest in the contractual amount. These are placements for which the present value of estimated future cash flows arising from these placements is lower than their gross carrying values.

(2) Loss on partly recoverable placements secured by eligible instruments of collateral shall be determined as a positive difference between the gross carrying amount of an individual placement and the present value of estimated future cash flows, discounted by applying the effective interest rate referred to in Article 20 of this Decision and by applying the provisions of Article 37, paragraphs (2), (3) and (4) of this Decision.

(3) A credit institution shall, upon identifying the loss on partly recoverable placements, first make a hundred-percent value adjustment of receivables based on interest income.

(4) The difference between the total identified loss referred to in paragraph (2) of this Article and the value adjustment referred to in paragraph (3) of this Article shall be the loss on receivables based on a placement principal, where the level of value adjustment may not be lower than 1% of the amount of the receivables based on the placement principal. Depending on the amount of loss on the principal of a partly recoverable placement, a credit institution shall classify the placement into an appropriate risk sub-category as follows:

- 1) where the identified loss does not exceed 30% of the amount of receivables based on the principal, the credit institution shall classify the placement into risk sub-category B-1;
- 2) where the identified loss exceeds 30%, but does not exceed 70% of the amount of receivables based on the principal, the credit institution shall classify the placement into risk sub-category B-2; and
- 3) where the identified loss exceeds 70% but is lower than 100% of the amount of receivables based on the principal, the credit institution shall classify the placement into risk sub-category B-3.

(5) By way of derogation from paragraph (4) of this Article, where the amount of the identified loss referred to in paragraph (2) of this Article is lower than or equal to the receivables based on interest income, a credit institution shall make a value adjustment of receivables based on the principal in the amount of at least 1% and shall classify the placement into risk sub-category B-1.

(6) By way of derogation from paragraph (2) of this Article, where the period within which future cash flows from an individual placement are expected is shorter than one year, counting from the balance sheet date, a credit institution shall not be obliged to calculate the present (discounted) value of estimated future cash flows. In that case, the credit institution may determine the loss as a positive difference between the gross carrying amount of the placement and the estimated future cash flows from that placement. This derogation only applies in the cases where a credit institution can prove the certainty of cash flows by adequate documentation and where it is possible to reliably measure the final settlement period and the total amount of cash flows into the credit institution on that basis. In some cases this will not be likely as long as a fee has not been received and the uncertainty, taking into account all the risks, has not been removed.

(7) A credit institution shall calculate the amount of loss from partly recoverable placements individually for each placement, which constitutes a part of individually significant exposure, the carrying amount of which exceeds the amount referred to in Article 9 of this Decision.

(8) By way of derogation from paragraph (7) of this Article, a credit institution may determine the loss on placements for several placements together, as follows:

- 1) for placements that belong to a portfolio of small loans referred to in Article 11 of this Decision, which have similar characteristics with respect to their purpose, maturity, interest rate, instruments of collateral, etc., and
- 2) for all placements to a single debtor against whom bankruptcy proceedings have been initiated, except for receivables from a bankruptcy debtor where a credit institution is a creditor with a right to separate satisfaction, for which a recoverable amount or the amount of loss is assessed individually.

### **Effective interest rate**

#### **Article 20**

(1) For the purpose of discounting the expected future cash flows arising from partly recoverable placements, a credit institution shall apply as the initial (original) effective interest rate the annual percentage rate (APR), which is computed at the conclusion of the credit contract, in accordance with the methodology set out in the decision governing the manner of calculating the effective interest rate on loans and deposits. The annual percentage rate (APR) is the rate which does not include the effect of security deposit flows in calculating the effective interest rate. If, in the case of financial difficulties of a debtor, the lending terms and conditions, concerning the level and time limits for repayment, are modified by a subsequent annex to the contract, the initial rate (APR), which was determined prior to the modification of the contract, shall be used for discounting the expected future cash flows arising from these placements.

(2) For discounting the expected future cash flows arising from partly recoverable placements, where the initial contract contains the interest rate variability clause or where the originally contracted interest rate was changed by a subsequent annex to the contract, a credit institution shall apply the current/present effective interest rate. The application of the current/present effective interest rate shall imply the application of the annual percentage rate (APR) computed at the time of determining the present value of the expected future cash flows arising from partly recoverable placements.

(3) When the present value of the expected future cash flows for partly recoverable placements is determined for the placements which were not subject to effective interest rate computation at the time of approval, a credit institution shall calculate the annual percentage rate (APR) for the purpose of discounting the future cash flows, on the basis of the initial contractual provisions, applying the fixed or current/present interest rate in accordance with paragraphs (1) and (2) of this Article.

### **Accounting for impairment of placements**

#### **Article 21**

(1) A credit institution shall recognise the impairment of partly recoverable placements (in the amount of loss identified in accordance with Articles 18 and 19 of this Decision) in the profit and loss account, by debiting expenses of a credit institution for the period when the losses are identified, and in the balance sheet assets, by crediting the value adjustments account of placements to which these adjustments relate.

(2) Provided that, upon the initial impairment of placements, the loss has increased at a subsequent assessment (which is performed at least once in a quarter) due to altered circumstances affecting the assessment, the amount of increased loss shall be accounted for by the credit institution in accordance with paragraph (1) of this Article.

(3) Provided that the loss, referred to in paragraph (1) of this Article, is reduced, the amount of reduction shall be recognised by the credit institution in profit or loss, by crediting the account where value adjustment expense was previously recognised, and in the balance sheet assets, by debiting the value adjustments account of placements to which these adjustments relate.

### **2.5.3 RECOGNITION OF INTEREST INCOME FROM PARTLY RECOVERABLE PLACEMENTS**

#### **Recognition of interest income from partly recoverable placements**

##### **Article 22**

(1) It is deemed that there is uncertainty as regards the collection of interest income from partly recoverable placements and recognition of that income in profit or loss is postponed until its collection. Receivables on the basis of interest income, referred to in this paragraph, shall be recorded in the credit institution's business books in the off-balance sheet accounts.

(2) If, at the time of reclassification of placements from risk category A into risk sub-category B-1 or worse there are uncollected receivables based on interest income that was recognised, in the previous period, in profit or loss, a credit institution shall perform value adjustment of the uncollected receivables in the amount of the interest income previously recognised in profit or loss (100%). These receivables shall remain in the balance sheet accounts until they are collected or until legal actions are taken concerning the termination of the debtor's liability, in accordance with the credit institution's policies and procedures and the law regulating civil obligations.

### **2.5.4 FULLY IRRECOVERABLE PLACEMENTS (RISK CATEGORY C)**

#### **Fully irrecoverable placements**

##### **Article 23**

(1) Fully irrecoverable placements shall be credit institution's receivables acquired on disputable legal basis and other receivables for which, due to especially low creditworthiness of a debtor and a lack of any eligible instrument of collateral, no cash flows can be expected for settling debtor's liabilities towards a credit institution.

(2) Placements referred to in paragraph (1) of this Article shall be classified by a credit institution into risk category C, in accordance with this Decision.

(3) It is deemed that present value of receivables graded C equals zero and that impairment loss, i.e. value adjustment of these placements amounts to 100% of their gross carrying amount.

(4) A credit institution shall record the impairment loss, i.e. value adjustment referred to in paragraph (3) of this Article in the business books, in accordance with Article 21 of this Decision.

(5) Placements classified into risk category C and for which a 100%-value adjustment has been performed shall be recorded by the credit institution in the balance sheet accounts until legal actions are taken concerning the termination of debtor's liabilities, in accordance with the credit institution's policies and procedures and the law regulating civil obligations.

## 2.5.5 TREATMENT OF RESTRUCTURED PLACEMENTS

### Treatment of restructured placements Article 24

(1) A credit institution shall define criteria for the:

- restructuring of placements, taking into account the provisions of paragraphs (2), (3) and (6) of this Article; and
- treatment of restructured placements during the entire credit relationship, taking into account the provisions of paragraphs (4), (5), and (7) of this Article.

(2) A credit institution shall classify a restructured placement that was classified into risk category A prior to its restructuring at least into risk subcategory B-1.

(3) A credit institution shall classify a restructured placement that was classified into one of the sub-categories of risk category B prior to its restructuring into the risk sub-category into which the placement was classified prior to the restructuring or worse.

(4) Depending on the type, characteristics and amount of a placement, a credit institution shall prescribe the conditions and time limits for the classification of the restructured placements referred to in paragraphs (2) and (3) of this Article into a risk category/sub-category involving a lower degree of credit risk, ensuring that at least the following conditions are met:

- 1) the restructuring of the placement is part of the overall restructuring of a debtor's business operations or financial position;
- 2) the debtor's financial position is based on reliable cash flows; and
- 3) the regular repayment of the restructured placement within a period of at least 12 months has been established.

(5) After the conditions referred to in paragraph (4) of this Article have been met, a credit institution may, in the event of a new classification, classify the restructured placement at a 12-month-interval into a risk category/sub-category involving a lower degree of credit risk.

(6) By way of derogation from paragraph (2) of this Article, a credit institution may continue to classify the restructured placements graded A before restructuring into risk category A, provided that, in addition to the criteria for the classification into risk category A referred to in Article 14, paragraph (2) of this Decision and criteria laid down in the internal monitoring system, the following additional conditions are met:

- 1) the restructuring of the placement is part of the overall restructuring of a debtor's business operations or financial position;
- 2) the debtor is expected to settle its liabilities to the credit institution based on a restructured placement within the contracted time limits; and
- 3) the debtor's financial position is expected to be based on reliable cash flows.

(7) Until the expiry of a 12-month period from the restructuring, a credit institution may recognise in its profit and loss account only the collected interest income arising from the restructured placement referred to in paragraph (6) of this Article. Where in this period a debtor has overdue liabilities for more than 60 days, the credit institution shall classify the restructured placement into risk sub-category B-1 or worse. The credit institution shall include the restructured placements graded A in the ex-post monitoring system referred to in Article 13, paragraph (3) of this Decision.

### **3 CLASSIFICATION OF ASSUMED OFF-BALANCE SHEET LIABILITIES INTO RISK CATEGORIES**

#### **3.1 SUBJECT OF CLASSIFICATION**

##### **Off-balance sheet liabilities classified into risk categories Article 25**

(1) Irrevocably assumed off-balance sheet liabilities, which can be allocated to individual customers, and on the basis of which a credit institution is exposed to credit risk due to uncollectibility of the outflow of funds which may occur or which occurs in settling of the assumed off-balance sheet liabilities, shall be classified into the appropriate risk categories.

(2) Off-balance sheet liabilities, referred to in paragraph (1) of this Article shall be the following:

- 1) issued guarantees,
- 2) opened uncovered letters of credit,
- 3) letters of guarantee and other commitments,
- 4) granted but not used irrevocable credit lines and other similar loans,
- 5) concluded but not implemented irrevocable financial leasing, factoring and forfeiting contracts, and
- 6) other irrevocably assumed off-balance sheet liabilities, for the settling of which outflow of credit institution's funds will occur or might occur, on the basis of which a credit institution is exposed to credit risk.

(3) If a credit institution makes payment on the basis of the assumed off-balance sheet liability, the initially assumed liability shall no longer be treated as an off-balance sheet item, but shall become a balance sheet category to which the provisions of this Decision apply, relating to placements, i.e. on-balance sheet items.

#### **3.2 CLASSIFICATION CRITERIA**

##### **Off-balance sheet liabilities classification criteria Article 26**

(1) The main criteria for off-balance sheet liabilities classification into risk categories shall be the following:

- 1) creditworthiness of a person to whom a credit institution has assumed a financing liability, i.e. on whose order a credit institution has opened an uncovered letter of credit, issued a guarantee or another commitment, and
- 2) quality of instrument of collateral for receivables which may occur on the basis of payment of off-balance sheet liability.

(2) Timeliness in meeting the obligations of a person referred to in paragraph (1) of this Article towards a credit institution in the previous period, if the same person was at the time a credit

institution's debtor, may be an additional criterion for classification of off-balance sheet liabilities into risk categories.

### **3.3 CLASSIFICATION OF OFF-BALANCE SHEET LIABILITIES ACCORDING TO THEIR SIGNIFICANCE**

#### **Assessment of loss for individually significant exposure Article 27**

(1) A credit institution shall assess individually credit risk or provisions for losses arising from off-balance sheet liabilities, constituting an integral part of individually significant exposure referred to in Article 9 of this Decision.

(2) Individual assessment of credit risk, referred to in paragraph (1) of this Article, shall imply the procedure involving the assessment of recoverability of the future outflow of funds, separately for each assumed off-balance sheet liability constituting an integral part of significant exposure to a single person referred to in Article 9 of this Decision.

#### **Assessment of loss for an exposure that is not individually significant Article 28**

(1) A credit institution shall assess individually or collectively credit risk or provisions for losses that may be incurred due to irrecoverability of outflow of its funds for the purpose of paying off-balance sheet liabilities, assumed towards a person or for the account of a person to whom overall exposure of a credit institution does not exceed the amount referred to in Article 9 of this Decision.

(2) Individual assessment of credit risk or provisions for losses, referred to in paragraph (1) of this Article, shall imply the procedure of assessment of recoverability of the future outflow of funds, individually for each off-balance sheet liability that is a part of exposure that is not individually significant.

(3) Notwithstanding paragraph (2) of this Article, a credit institution may apply an alternative procedure for the assessment of credit risk or provisions for losses that may be incurred due to irrecoverability of outflow of funds for the purpose of paying off-balance sheet liabilities which are a part of exposure to a single person, which is not individually significant. The assessment of recoverability of the future outflow of funds may be performed for several similar off-balance sheet liabilities together.

### **3.4 CLASSIFICATION OF OFF-BALANCE SHEET LIABILITIES INTO RISK CATEGORIES**

#### **General classification of off-balance sheet liabilities by a degree of risk Article 29**

(1) With respect to the assessed possibility of recovering the expected outflow of a credit institution for the purpose of settling off-balance sheet liabilities, these liabilities are classified into three broader categories as follows:

- 1) off-balance sheet liabilities for which no outflow of credit institution's funds is expected, or if the outflow occurs, it is expected to be fully recovered (risk category A),
- 2) off-balance sheet liabilities for which outflow of credit institution's funds is expected that will not be fully recoverable (risk category B, consisting of risk sub-categories B-1, B-2 and B-3), and
- 3) off-balance sheet liabilities for which outflow of credit institution's funds is expected that will be fully irrecoverable (risk category C).

(2) As regards the criteria for off-balance sheet liabilities classification into risk categories, the provisions of Article 5 of this Decision shall apply *mutatis mutandis*.

### **3.4.1 OFF-BALANCE SHEET LIABILITIES FOR WHICH NO LOSSES ARE IDENTIFIED (RISK CATEGORY A)**

#### **Classification of off-balance sheet liabilities into risk category A Article 30**

(1) A credit institution shall initially classify contractual off-balance sheet liabilities into risk category A.

(2) It shall be deemed that conditions for classification of off-balance sheet liabilities into risk category A are fulfilled if, on the basis of the present financial condition and estimated future cash flows of a person to whom a credit institution is exposed to credit risk, it is assessed that there will be no outflow of credit institution's funds for settling of off-balance sheet liabilities or if the outflow does occur, it will be fully recovered.

#### **Subsequent assessment of off-balance sheet liabilities graded A Article 31**

(1) During the period of contractual relationship, a credit institution shall perform on a regular basis, and at least every three months, subsequent assessment of riskiness of off-balance sheet liabilities that were initially, at the beginning of the contractual relationship, classified into risk category A. If it has been established by the subsequent assessment that circumstances have changed, on the basis of which off-balance sheet liabilities were initially classified into risk category A, regardless of whether these off-balance sheet liabilities constitute an integral part of individually significant exposure, a credit institution shall classify these off-balance sheet liabilities into risk sub-category B-1 or worse.

(2) Off-balance sheet liabilities graded A, for which no losses are identified at subsequent assessment, i.e. for which it has been established that provisions for losses on individual basis are not required, regardless of whether these off-balance sheet liabilities constitute an integral part of individually significant exposure, shall remain classified into risk category A until further notice. For

these off-balance sheet liabilities, a credit institution shall perform collective assessment of credit risk and make collective provisions for losses.

(3) Losses referred to in paragraph (2) of this Article shall imply losses for which there is no evidence on the basis of which a direct relation could be made to an individual liability constituting an integral part of individually significant exposure, i.e. to several similar off-balance sheet liabilities constituting an integral part of exposure that is not individually significant, but for which it may be assessed, on the basis of historical loss experience, that they exist as latent losses related to off-balance sheet liabilities graded A.

(4) Assessment of provisions for losses referred to in paragraph (2) of this Article shall be performed by a credit institution in accordance with Article 32 of this Decision, taking into account the principles of the International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets (hereinafter: IAS 37).

#### **Provisions for off-balance sheet liabilities graded A on collective basis**

##### **Article 32**

(1) A credit institution may make provisions for losses on a collective basis arising from off-balance sheet liabilities graded A by applying its internal experience-based methodology, prepared and tested in advance, where the level of the provisions may not be lower than 0.80% of the total balance of off-balance sheet liabilities graded A.

(2) A credit institution having no internal methodology shall maintain the level of provisions for off-balance sheet liabilities graded A on a collective basis to a minimum of 1% of the total balance of off-balance sheet liabilities graded A.

(3) The amount of provisions for losses on a collective basis arising from off-balance sheet liabilities graded A shall be accounted for by debiting expenses of a credit institution for the period when the losses are identified and by crediting the corresponding provisions accounts in the balance sheet liabilities.

(4) The credit institution referred to in paragraph (1) of this Article shall, at least once a year, review its internal methodology for the assessment of credit risk arising from off-balance sheet liabilities and shall revise it, where necessary, for the purpose of reducing the differences between the estimated and actual latent losses related to off-balance sheet liabilities graded A.

#### **3.4.2 OFF-BALANCE SHEET LIABILITIES FOR WHICH OUTFLOW OF FUNDS IS EXPECTED THAT WILL NOT BE FULLY RECOVERABLE (RISK CATEGORY B)**

##### **Off-balance sheet liabilities with partly recoverable outflow of funds**

##### **Article 33**

(1) Off-balance sheet liabilities, referred to in Article 30 of this Decision, for which it has been established by subsequent assessment that they no longer meet the conditions for classification into risk category A (regardless of whether they constitute an integral part of individually significant exposure) shall be classified into the appropriate sub-category involving a higher degree of credit risk (B-1, B-2 or B-3).

(2) Off-balance sheet liabilities assumed towards a person or for the account of a person whose financial position is not satisfactory, i.e. whose financial position has deteriorated after the assumption of an off-balance sheet liability and after the occurrence of the past obligating event, shall be classified into the appropriate risk sub-category referred to in paragraph (1) of this Article. Those are off-balance sheet liabilities for which it is estimated that, for the purpose of their settling, an outflow of credit institution's funds will occur and the assessment of the future cash flows of a person towards whom or for whose account a credit institution has assumed a liability, as well as the quality of eligible instruments of collateral, point to a conclusion that the credit institution will not be able to recover in entirety all to which it is entitled under the contract, on the basis of the expected outflow of funds for the purpose of paying an off-balance sheet liability.

(3) Depending on the amount of the estimated loss due to a lack of possibility to fully recover the expected outflow of funds for the purpose of settling off-balance sheet liabilities, a credit institution shall classify these liabilities into the following risk sub-categories:

- 1) into risk sub-category B-1 (off-balance sheet liabilities where the amount of the required provision does not exceed 30% of the amount of the expected outflow for settling the liabilities),
- 2) into risk sub-category B-2 (off-balance sheet liabilities where the required provisions are between more than 30% and 70% of the amount of the expected outflow for settling the liabilities), or
- 3) into risk sub-category B-3 (off-balance sheet liabilities where the required provisions are between more than 70% and less than 100% of the amount of the expected outflow for settling the liabilities).

### **3.4.3 OFF-BALANCE SHEET LIABILITIES FOR WHICH OUTFLOW OF FUNDS IS EXPECTED THAT WILL BE FULLY IRRECOVERABLE (RISK CATEGORY C)**

#### **Off-balance sheet liabilities with fully irrecoverable outflow of funds Article 34**

(1) Off-balance sheet liabilities for which a credit institution has established at a subsequent assessment (regardless of whether they constitute an integral part of individually significant exposure) that an outflow of its funds will occur for settling of these liabilities and that this outflow cannot not be even partly recovered shall be classified by a credit institution into risk category C.

(2) Risk category C encompasses off-balance sheet liabilities assumed towards a persons or for the account of a person whose financial position has significantly deteriorated after the assumption of an off-balance sheet liability, i.e. after the occurrence of the past obligating event, and it is very likely that an outflow of credit institution's funds will occur for settling the off-balance sheet liability, and the assessment of the future cash flows of a person to whom a credit institution is exposed, as

well as the quality of eligible instruments of collateral, point to a conclusion that the credit institution, after settling the assumed liability, will not be able to recover anything to which it is entitled under the contract.

#### **3.4.4 PROVISIONS FOR IDENTIFIED LOSSES ON THE BASIS OF OFF-BALANCE SHEET LIABILITIES**

##### **Provisions for identified losses**

##### **Article 35**

(1) Provisions for identified losses for off-balance sheet liabilities referred to in Articles 33 and 34 of this Decision shall be determined in the amount reflecting the best estimate, based on the procedures and policies of a credit institution and IAS 37 principles.

(2) The amount of provisions referred to in paragraph (1) of this Article shall be equal to the amount of the expected future expenditures for settling the off-balance sheet liabilities which a credit institution will not be able to recover.

(3) Notwithstanding the provision of paragraph (2) of this Article, where the effect of the time value of money is material, the amount of provisions referred to in paragraph (1) of this Article shall be equal to the discounted value of the expected future irrecoverable outflows required to settle the off-balance sheet liability (present value of irrecoverable future outflows). The amount of the expected outflows is discounted to their present value at every balance sheet date, at the discount rate reflecting the current market value of money.

(4) In terms of paragraph (3) of this Article, the effect of the time value of money shall be deemed to be material where it is estimated that the outflow of resources required to settle the off-balance sheet liability will occur within a period exceeding one year, counting from the balance sheet date.

(5) Outflows (which a credit institution will not be able to recover) shall imply the amount of the expected outflows required to settle off-balance sheet liabilities reduced by the amount assessed with certainty as fully recoverable either by the counterparty or by activating the available instrument of collateral.

(6) The amount of provisions for losses arising from off-balance sheet liabilities classified into risk categories B and C, shall be accounted for by debiting expenses of a credit institution for the period when these losses are identified and by crediting the corresponding provisions account in the balance sheet liabilities.

(7) The level of provisions for losses arising from off-balance sheet liabilities may not be lower than 1% of the amount of the off-balance sheet liabilities.

#### **4 RATING OF INSTRUMENTS OF COLLATERAL**

##### **First-class instruments of collateral**

## **Article 36**

(1) Instruments of collateral that may be recognised in placements classification as first-class instruments are the following:

- 1) items referred to in Article 197, paragraph (1), items (a), (b), (c), (d), (e) and (g) of Regulation (EU) No 575/2013,
- 2) guarantees and commitments which are irrevocable and payable upon first demand, issued by the central governments, central banks and export credit agencies referred to in Article 197, paragraph (1), item (b) of Regulation (EU) No 575/2013, and
- 3) guarantees and commitments which are irrevocable and payable upon first demand, issued by the credit institutions with a credit assessment determined in accordance with Article 197, paragraph (1), item (c) of Regulation (EU) No 575/2013.

(2) Where a security, referred to in paragraph (1), item (1) of this Article, has two credit assessments by eligible external credit assessment institutions, the less favourable assessment shall be applied by a credit institution. In cases where a security has more than two credit assessments by eligible external credit assessment institutions, a credit institution shall determine the two most favourable assessments and shall apply the less favourable of the two.

(3) In addition to debt securities referred to in Article 197, paragraph (1), item (b) of Regulation (EU) No 575/2013, the first-class instruments of collateral in a form of debt securities issued by central governments or central banks, shall also include the items referred to in Article 197, paragraph (2) of Regulation (EU) No 575/2013 in accordance with the Decision implementing Regulation (EU) No 575/2013.

(4) In addition to debt securities referred to in Article 197, paragraph (1), item (c) of Regulation (EU) No. 575/2013, the first-class instruments of collateral in a form of debt securities shall also include the items referred to in Article 197, paragraph (3) of Regulation (EU) No 575/2013.

(5) For the purpose of this Decision, other instruments equal in quality to the individually listed instruments of collateral, referred to in paragraphs (1), (3) and (4) of this Article, shall also be deemed first-class instruments of collateral for receivables.

## **Appropriate instruments of collateral in a form of real-estate and movable property**

### **Article 37**

(1) Appropriate instruments of collateral in a form of real estate or movable property shall be taken into account by a credit institution in classification of placements or assumed off-balance sheet liabilities, if it has at its disposal all the required documentation from which it is evident that the respective real estate or movable property represents an efficient and proper secondary source of collection. Instrument of collateral in a form of real estate or movable property shall be deemed to have these characteristics if a credit institution has been provided with the evidence that there is a market allowing for an expeditious and economically efficient (at an adequate price) liquidation of collateral.

(2) In the estimation of future cash flows arising from the collections related to real estate and movable property, a credit institution shall apply the appropriate impairment factors with respect to the market price and an appropriate internally estimated collection period. The impairment factors and collection period shall take into account the credit institution's practice and past experience in the collection of the appropriate instruments of collateral, the economic and legal environments in which the credit institution operates and the appropriate characteristics of instrument of collateral. In determining the amount of the impairment factor and duration of the collection period, a credit institution shall take account of the fact that different types of instruments of collateral reflect different levels of risk.

(3) The impairment factors and collection period referred to in paragraph (2) of this Article may not be lower than the minimum benchmark values referred to in Appendix 1, which constitutes an integral part of this Decision.

(4) Credit institutions shall, at least once a year, review the validity of assumptions about the initially set collection periods and adjust them, where necessary.

(5) A credit institution may, in each quarter, reduce the collection period in accordance with the time passed only after actions have been taken to call on an instrument of collateral, if it assesses that the collection is carried out in accordance with the initially set period. This reduction can only be made in the cases where a credit institution can prove the certainty of cash flows by adequate documentation and where it is possible to reliably measure the final settlement period and the total amount of cash flows into the credit institution on that basis.

(6) A credit institution shall, in assessing cash flows and after determining the present value in accordance with the provisions of this Decision, take into account that portion of the value of collateral in a form of real estate, which remains after deducting all liabilities secured by the same real estate, which are registered in the land registry with a higher priority rank or after deducting a proportional part of liabilities that have the same priority rank as the receivables of the respective credit institution.

(7) Market price shall be taken as the value of an instrument of collateral in a form of real estate. Provided that there is no active market for an individual type of real estate, i.e. provided that market price is not available, the most recent valuation of the real estate market value executed by an independent valuer shall be taken into account. In that valuation, the independent valuer shall take into account all the costs associated with the sale. A purchase and sale contract, concluded no later than one year before, may be taken into account as an alternative method for determining the real estate value for commercial real estate.

(8) A credit institution shall have the following documents related to the real estate property used as an instrument of collateral for receivables:

- 1) public notary contract on the registration of mortgage or fiduciary transfer of ownership on the respective real estate property,
- 2) court decision concerning the registration of mortgage or fiduciary transfer of ownership on the respective real estate property in the land registry,

3) updated land registry certificate, with the registered mortgage or fiduciary transfer of ownership,  
4) insurance policy for the respective real estate property, with transferability restricted to a credit institution (except where the real estate property is an undeveloped land), and  
5) valuation executed by an independent valuer or a purchase and sale contract for the respective real estate property.

(9) In the course of contractual relationship, a credit institution shall continuously monitor the value of real estate accepted as collateral for its receivables, at a minimum once every year for commercial real estate and once every three years for residential real estate. More frequent monitoring shall be carried out by the credit institution where the market is subject to significant changes in conditions. Statistical methods may be used to monitor the value of the property and to identify property that needs revaluation. If a credit institution has established, on the basis of monitoring, that the value of the property may have declined materially relative to general market prices, it shall request from an independent valuer to review the property valuation.

(10) For placements exceeding 5% of own funds of a credit institution or exceeding HRK 20m (whichever is the lower), the credit institution shall ensure property valuation by an independent valuer at least every three years. The credit institution shall ensure that an independent property valuation for these placements is not older than 3 years from the date of entry into force of this Decision.

(11) In calculating impairment of placements and provisions for losses arising from off-balance sheet liabilities, the credit institution may use a movable property as an eligible instrument of collateral, if the following conditions are met:

- 1) there is a liquid market allowing for an expeditious and economically efficient (at an adequate price) disposal of the collateral,
- 2) market prices for the respective movable property are available,
- 3) operational conditions for executing sales are fulfilled,
- 4) collateral arrangements enable realisation of value of the property within a reasonable timeframe,
- 5) there is a first priority claim over all other creditors,
- 6) a proper control is in place of the value of collateral at a minimum once every year and on a more frequent basis where the market is subject to significant price changes,
- 7) credit contract, i.e. contract on off-balance sheet liability, shall include detailed descriptions of the collateral,
- 8) a credit institution has a list of eligible types of collateral in a form of movable property, and it has determined by its internal by-law processes and procedures concerning the required coverage for an individual type of collateral, including the ratio of value of receivables to collateral,
- 9) the credit institution's credit policies address appropriate collateral requirements relative to the amount of exposure to debtor, the ability to liquidate the collateral readily and the ability to establish objectively a price or market value of the collateral,
- 10) both initial valuation and revaluation of the respective movable property take fully into account any deterioration of the movable property or the effects of the passage of time on the valuation,
- 11) the credit institution has in place the procedures for a legal examination of validity of the lien on the respective movable property,
- 12) the lien is registered in the registry of liens on movable property at the institution competent for keeping that registry, and

13) the movable property is secured by an insurance policy with transferability restricted to the credit institution.

(12) A credit institution shall ensure movable property valuation by an independent valuer at least every three years, for movable property the value of which, at the time of negotiating the instrument of collateral, exceeded HRK 3 million. The credit institution shall ensure that the independent property valuation for this movable property is not older than 3 years from the date of entry into force of these provisions. For other instruments of collateral in a form of movable property, which serves as the basis for cash flow estimation and which is taken into account for the calculation of recoverability of placements, the credit institution may take, as the value of movable property, the purchase and sales price reduced by the depreciation amount, the value of the movable property from the insurance policy, or the market value which is easily accessible, transparent and determined in accordance with professional standards.

### **Other appropriate instruments of collateral**

#### **Article 38**

(1) In addition to instruments referred to in Article 37 of this Decision, debt securities issued by institutions which securities do not have a credit assessment by an eligible external credit assessment institution may be recognised by the credit institution as appropriate instruments of collateral but only if all the conditions referred to in Article 197, paragraph (4) of Regulation (EU) No 575/2013 are met.

(2) A credit institution may recognise units or shares in collective investment undertakings as appropriate instruments of collateral if all the conditions referred to in Article 197, paragraph (5) of Regulation (EU) No 575/2013 are met.

(3) For the purposes of this Decision, the provisions of Article 197, paragraph (5) subparagraphs (2) and (3) of Regulation (EU) No 575/2013 shall apply to units or shares in collective investment undertakings.

(4) A credit institution may recognise equities or convertible bonds that are included in the main stock exchange index as appropriate instruments of collateral.

(5) In the estimation of future cash flows arising from the collections related to the equities or convertible bonds referred to in paragraph (4) of this Article, a credit institution shall apply the appropriate impairment factors with respect to the market price, taking into account the volume and frequency of trading in the respective equities or convertible bonds, past experience in the collection of equities or convertible bonds, the economic and legal environments in which the credit institution operates and the appropriate characteristics of the equities or convertible bonds.

(6) Other appropriate instruments of collateral, in addition to those indicated in paragraphs (1) and (2) of this Article, shall encompass insurance policies for credit receivables and life insurance policies with a surrender value and other instruments of collateral equal in quality to the

instruments of collateral referred to in paragraphs (1) and (2) of this Article, on the basis of the appropriate evidence.

### **Ineligible instruments of collateral**

#### **Article 39**

All other instruments of collateral accepted by the credit institution, which are not encompassed by Articles 36 to 38 of this Decision (e.g. bills of exchange, promissory notes, debtor's statement of enforcement, guarantees of persons without the appropriate creditworthiness or without a credit assessment by an eligible external credit assessment institution) shall be deemed, in terms of this Decision, ineligible instruments of collateral, which the credit institution cannot take into account in assessing the future cash flows, i.e. for the purpose of impairment of placements or making provisions for losses arising from the assumed off-balance sheet liabilities.

## **5 KEEPING CREDIT RECORDS**

### **Contents of credit records**

#### **Article 40**

(1) A credit institution shall provide information and documentation on debtors by a systematic keeping of credit records. Credit records shall provide the basic information about a debtor, his financial status and position and about the nature of the credit relationship.

(2) Credit records shall contain at a minimum:

- 1) basic data on debtors (first and last name, address or company name, registered office, number of employees, ownership structure, management, connection of a debtor with other persons, if a debtor belongs to a group of connected persons in terms of the Credit Institutions Act),
- 2) main debtors and creditors of every debtor to whom credit institution's exposure is individually significant,
- 3) financial reports of a debtor for the last three years,
- 4) analysis and assessment of a financial and economic position of a debtor, including internal rating of a debtor,
- 5) evidence, if any, of impairment of debtor's financial assets, analysis and assessment of debtor's cash flows relative to his liabilities,
- 6) proposal for the transaction approval and opinion of an expert service and decision of the credit institution's body competent for transaction approval,
- 7) credit contract,
- 8) analytical bookkeeping records of on-balance and off-balance sheet items relating to an individual debtor of a credit institution,
- 9) documentation concerning instrument of collateral,
- 10) records on court proceedings initiated by a credit institution in order to collect its receivables,
- 11) records on court proceedings that may be initiated against a credit institution in order to decrease the plaintiff's liabilities towards a credit institution (e.g. to declare enforcement in favour of the credit institution wrongful, etc.), and

12) other documentation that may complement the information on the debtor's financial position.

(3) A credit institution shall adopt and implement the procedure for keeping credit records and shall appoint persons responsible for completeness and integrity of individual records.

## **6 REPORTING TO THE CROATIAN NATIONAL BANK**

### **Contents of reports and reporting time limits**

#### **Article 41**

(1) A credit institution shall report to the Croatian National Bank on the status of placements and off-balance sheet liabilities classified into risk categories in accordance with the provisions of this Decision.

(2) For the purpose of reporting to the Croatian National Bank, a credit institution shall allocate the collective impairment of placements graded A to individual placements, and shall allocate provisions for losses on a collective basis arising from off-balance sheet liabilities graded A to individual off-balance sheet liabilities.

(3) The reports, referred to in paragraph (1) of this Article, shall be submitted by the credit institution in a form, manner and within the time limits prescribed by a decision governing supervisory reports of credit institutions and the Decision on statistical and prudential reporting.

## **7 IMPAIRMENT OF FINANCIAL ASSETS AVAILABLE FOR SALE**

### **Impairment of financial assets available for sale**

#### **Article 42**

A credit institution shall perform the impairment of debt financial instruments assigned to the portfolio of available-for-sale financial assets by applying the criteria defined in the provisions of this Decision, with the exception of the provisions on subsequent collective assessment of placements classified into risk category A (Article 16), provisions on collective impairment of placements classified into risk category A (Article 17) and provisions on the contents of reports and reporting time limits (Article 41).

## **8 TRANSITIONAL AND FINAL PROVISIONS**

### **Application of provisions on increase in value adjustments**

#### **Article 43**

For all the placements referred to in Article 15, paragraph (5) of this Decision in relation to which, as at 1 July 2013, over two years have elapsed since the date of occurrence of a debtor's delinquency, the prescribed period of 180 days shall begin on 1 July 2013.

**Cessation of the effect of the previous Decision**

**Article 44**

On the date of entry into force of this Decision, the Decision on the classification of placements and off-balance sheet liabilities of credit institutions (Official Gazette 1/2009, 75/2009, 2/2010 and 89/2013) shall cease to have effect.

**Entry into force**

**Article 45**

This Decision shall be published in the Official Gazette and shall enter into force on 31 March 2014.

No.: 89-020/03-14/BV

Zagreb, 25 March 2014

Croatian National Bank

Governor

**Boris Vujčić**

(2)

**APPENDIX 1: An overview of instruments of collateral with the related impairment factors and expected collection periods (benchmark values used for the evaluation of instruments of collateral)**

No	Sub-type of instrument of collateral	Impairment factor (%)	Collection period (years)
1	Residential buildings*	10	2
2	Buildings with apartments for sale or rent**	20	2.5
3	Commercial buildings (offices)	20	2
4	Commercial premises (shopping centres, warehouses, shops, automotive stores ...)	30	2.5
5	Industrial facilities (factories, industrial plants, buildings, farms...)	50	4.5
6	Agricultural real estate (mills, silos...)	40	2.5
7	Building land	20	1.5
8	Agricultural land	40	2
9	Tourist facilities***	20	2
10	Right to build	30	2.5
11	Unfinished commercial areas – for business purposes	50	2
12	Unfinished commercial areas – for residential and mixed purposes	40	2
13	Unfinished tourist areas	20	2
	<b>MOVABLE PROPERTY****</b>		
14	General-purpose equipment and apparatus	60	3
15	Special-purpose equipment and apparatus	60	3
16	Passenger cars	60	1
17	Vehicles (commercial)	60	1.5
18	Ships	60	2
19	Aircrafts and helicopters	60	5
20	Stocks that are not under control of a credit institution	70	1
21	Stocks under control of a credit institution (locked up, the key is in the credit institution)	60	1
22	Precious metals and works of art – not deposited at the credit institution	60	1
23	Precious metals and works of art – deposited at the credit institution	40	1
24	Construction machinery	60	3
25	Manufacturing machinery	60	3

26	Agricultural machinery	60	3
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Notes:

\* individual apartments

\*\* provided that the building is completed and has an occupancy permit

\*\*\* a combination of all the three methods should be applied (I – cost method, II – comparison method and III – yield evaluation or profit capitalisation method)

\*\*\*\* provided that they have a valid insurance policy

For residential and commercial buildings with the residential and/or commercial surface area of more than 5 thousand square meters, the credit institution is obliged to apply all the three methods (\*\*\*) together with the related factors and years for the particular types of area referred to in the Table.

The registered encumbrances are deducted after determination of the present value.