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Decision on the classification of placements and contingent liabilities of credit unions and the determining of exposure to credit risk

(Official Gazette 71/2007 and 139/2022 – unofficial consolidated version)

Zagreb, February 2023

Decision on the classification of placements and contingent liabilities of credit unions and the determining of exposure to credit risk

I. GENERAL PROVISIONS

(1) This Decision prescribes:

- the criteria for the classification of placements and contingent liabilities into appropriate risk categories;
- the method of determining losses related to credit risk;
- the method of determining exposure to credit risk to one person and a group of connected persons;
- the method of keeping and maintaining credit records;
- the method of keeping records of and making provisions for litigations;
- the method of keeping records of disbursed financial aid.

(2) Within the meaning of this Decision, placements mean:

- granted loans
- receivables based on interest income (regular and default interest, including all types of fees included in the calculation of the effective interest rate on loans)
- receivables based on non-interest income (all types of fees and commissions earned by the credit union through the provision of services to credit union members)
- deposits with banks
- repayable financial aid to credit union members and
- other receivables in relation to which the credit union is exposed to the risk of loss due to default of debtor towards the bank.

Within the meaning of this Decision, contingent liabilities mean:

- issued guarantees
- avals (bill-of-exchange security)
- agreed, but not used irrevocable credit lines and other financing commitments and
- other similar contingent liabilities based on which payment may ensue by the credit union and based on which a claim from a client may arise.

(3) Credit unions shall classify all placements and contingent liabilities into appropriate risk categories in accordance with this Decision.

(4) A credit union shall adopt a regulation to govern, in detail, a method to systematically:

- determine and monitor (when entering into and over the course of duration of a business relationship) the creditworthiness of persons to which it is exposed and the quality of collateral securing the claims and contingent liabilities of the credit union
- determine the criteria to classify placements and contingent liabilities into risk categories according to the degree of risk in accordance with this Decision
- determine value adjustments and provisions to cover identified losses on an individual and a group basis
- keep credit records in accordance with this decision
- keep records of and make provisions for litigations conducted against the credit union and
- determine the criteria for disbursing financial aid to members of the credit union and the method of keeping records of such aid.

Under Article 1 of the Decision on the classification of placements and contingent liabilities of credit unions and the determining of exposure to credit risk (Official Gazette 139/2022), which enters into force on 1 January 2023, item (2) has been amended.

II CLASSIFICATION OF PLACEMENTS

(5) To make provisions for identified losses for placements in relation to which it is exposed to credit risk, depending on the estimated degree of risk, a credit union shall classify placements into five risk categories:

- fully recoverable placements (risk category A)
- partly recoverable placements (risk categories B, C and D) and
- irrecoverable placements (risk category E).

(6) The classification of placements into risk categories A to E is performed:

- according to the debtor's timeliness in meeting obligations
- according to the quality and value of collateral received and
- according to the debtor's creditworthiness.

(7) The debtor's timeliness in meeting obligations means their ability to fully settle obligations towards the credit union (based on principal, interest and other bases) in the agreed amount and within agreed time limits.

Within the meaning of this item, the debtor has not settled their obligation towards the credit union in accordance with the agreement where the credit union grants a new placement in exchange for the existing one (refinancing) or where it extends the time limit for the repayment of an existing placement, unless an analysis of the debtor's financial position shows that the refinancing or the extension of the time limit for repayment has not been caused by the debtor's poor financial position.

(8) The quality of placement collateral is determined based on:

- its marketability
- documentation and the ability of the credit union to monitor a particular collateral
- possibility of forced collection.

(9) The debtor's creditworthiness is assessed at least based on the following:

- the debtor's asset strength, including the debtor's ability to generate future cash inflow for debt repayment
- the debtor's total indebtedness
- the debtor's cash flows generated in the previous period and the expected future cash flows and
- the debtor's sensitivity to a possible change in economic and market operating conditions, particularly from the viewpoint of a possible change in the debtor's social status.

(10) By way of derogation from item (6) of this Decision, placements belonging to the portfolio of small loans may be classified into risk categories solely on the basis of the debtor's timeliness in meeting obligations towards the credit union.

The portfolio of small loans includes total placements to one person the gross balance of which (excluding impairments for value adjustment), as at the day of assessment or reporting, amounts to less than EUR 2,000.

Credit unions shall classify placements belonging to the portfolio of small loans into risk categories as follows:

- into risk category A where there are no past due receivables, or where there are past due receivables, but the debtor has been overdue for less than 90 days counting from the date of maturity
- into risk category B where there are past due receivables based on said placements that have not been collected within 90 days from the date of maturity
- into risk category C where there are past due receivables based on said placements that have not been collected within 120 days from the date of maturity
- into risk category D where there are past due receivables based on said placements that have not been collected within 180 days from the date of maturity
- into risk category E where there are past due receivables based on said placements that have not been collected within 365 days from the date of maturity

(11) By way of derogation from the second paragraph of item (10), a credit union may prescribe in the regulation referred to in item (4) of this Decision a smaller amount as the upper limit for including a placement in the portfolio of small loans.

Fully recoverable placements (risk category A)

(12) Placements for which it is assessed that they will be fully collected in accordance with the agreement (principal, interest and receivables on other bases) shall be classified into risk category A. Interest income from placements classified into risk category A shall be recognised in the income statement in the accounting period they refer to.

(13) Where inability to collect the placement in the agreed amount occurs (principal and interest), or where circumstances arise which require the placement to be classified as a partly recoverable placement and where, at the same time, a past due receivable exists under the placement based on interest income which was recognised in the income statement in the preceding accounting period, a provision shall be made in the amount of 100% of the uncollected receivable based on the previously recognised interest income.

The cost of provisions for identified losses from receivables based on interest income shall be included in the income statement for the period in which the quality of the placement deteriorated, i.e., in which circumstances arose requiring the placement to be classified as a partly recoverable placement.

Partly recoverable placements (risk categories B, C and D)

(14) Placements for which objective evidence is available proving that their recoverable amount is lower than 90% and higher than or equal to 10% of their nominal accounting value shall be classified into risk categories B, C and D.

Credit unions shall, in their regulation referred to in item (4) of this Decision, regulate in more detail the criteria for determining future cash inflows based on partly recoverable placements according to which they shall, depending on the recoverable amount, classify placements as follows:

- placements the recoverable amount of which is equal to or higher than 70%, but lower than 90% of the nominal accounting value of the placement shall be classified into category B
- placements the recoverable amount of which is equal to or higher than 30%, but lower than 70% of the nominal accounting value of the placement shall be classified into category C
- placements the recoverable amount of which is equal to or higher than 10%, but lower than 30% of the nominal accounting value of the placement shall be classified into category D.

(15) For the purposes of calculating the percentage referred to in the preceding item, the recoverable amount of placement means the final value of the expected inflow to be used for settling the receivables based on the placement principal and the nominal accounting value of the placement means the balance of receivables based on the principal as entered in the business books on the date when future cash inflows are estimated.

(16) For placements classified into categories B, C or D, credit unions shall carry out value adjustments in the amount of the difference between the nominal accounting value of placement principal and the final amount of expected inflow to be used to settle the receivable based on the placement principal. The identified loss shall be recorded in the credit union's income statement as the expense on the value adjustment of placement principal in relation to which losses have been identified on an individual basis and in the balance sheet as the value adjustment of a partly recoverable placement.

(17) Credit unions shall, at least quarterly, perform the re-assessment of expected future inflows based on partly recoverable placements. Where it is established during re-assessment that the loss is higher than the reported value adjustment, the amount of loss increase shall be entered in the credit union's business books in accordance with item (16) of this Decision.

(18) Where it is established during re-assessment that the loss is lower than the reported value adjustment, the impairment amount shall be recognised in the income statement as income from cancelled value adjustment (entered on the credit side of the account where the value adjustment expense was previously entered on the debit side). In the balance sheet, the decrease in the value adjustment of a partly recoverable placement shall be entered as a counterpart item.

(19) Receivables based on calculated interest income under partly recoverable and irrecoverable placements (following classification into risk categories B, C, D or E) shall be entered into business books in the off-balance sheet records. Calculated interest income entered in the off-balance sheet records shall be recognised in the income statement as at the day of collection.

Fully irrecoverable placements (risk category E)

(20) Credit union placements that do not meet the criteria for classification into risk categories A, B, C or D, i.e., placements for which it is assessed that they cannot be collected from the debtor's inflow or collateral and are fully irrecoverable or recoverable in an amount whose final recoverable assessed amount does not exceed 10% of the nominal accounting value of the placement, shall be classified into risk category E.

(21) By way of derogation from the preceding item, all credit union receivables based on non-interest income that have not been collected within 90 days from the day of maturity shall be classified into risk category E.

(22) For placements classified into risk category E, credit unions shall report a loss in the amount of the accounting value of the principal of such placements. The loss shall be entered into the credit union's business books as the expense of value adjustment for identified losses on an individual basis in the income statement for the period in which the loss was identified and in the balance sheet as a value adjustment of a fully irrecoverable placement.

Under Article 2 of the Decision on the classification of placements and contingent liabilities of credit unions and the determining of exposure to credit risk (Official Gazette 139/2022), which enters into force on 1 January 2023, in item (7) the words "the debtor shall not be considered to have" have been replaced by the words "the debtor has not".

Under Article 3 of the Decision on the classification of placements and contingent liabilities of credit unions and the determining of exposure to credit risk (Official Gazette 139/2022), which enters into force on 1 January 2023, in item (10) the words "HRK 15,000" have been replaced by the words "EUR 2,000".

Under Article 4 of the Decision on the classification of placements and contingent liabilities of credit unions and the determining of exposure to credit risk (Official Gazette 139/2022), which enters into force on 1 January 2023, in item (20) the words "are considered" have been replaced by the word "are".

III CLASSIFICATION OF CONTINGENT LIABILITIES

(23) Classification of contingent liabilities shall be performed based on:

- probability of outflow of credit union funds for the purpose of settling assumed obligations and
- recoverability of the outflow incurred.

(24) Within the meaning of this Decision, contingent liabilities shall be classified into five risk categories as follows:

- contingent liabilities based on which no outflows of credit union funds are expected or in relation to which it is expected that, if an outflow does occur, it will be fully recovered, shall be classified into category A
- contingent liabilities based on which an outflow of credit union funds higher than the estimated recoverable amount is expected shall be classified into categories B, C and D and
- contingent liabilities based on which an outflow of credit union funds is expected which is estimated as fully irrecoverable shall be classified into category E.

(25) The criteria referred to in items (6) to (9) of this Decision shall apply *mutatis mutandis* to the classification of contingent liabilities into risk categories.

(26) Credit unions shall prescribe in detail the policies and procedures for the classification of contingent liabilities into risk categories in the general regulation referred to in item (4) of this Decision.

Risk category A

(27) Contingent liabilities shall be classified into risk category A where it is estimated that the current financial position and estimated future cash flows of a person in relation to which the credit union is exposed to credit risk based on the occurrence of a contingent liability do not indicate that an outflow of credit union funds is probable or where, if an outflow does occur, it is estimated that it will be fully recovered from that person's regular inflow or collateral.

Risk categories B, C and D

(28) Contingent liabilities shall be classified into risk categories B, C or D where the following two conditions are met:

- if there is a high probability that the credit union will have to execute payment based on these contingent liabilities and
- where projected future cash flows of a person for the account of which the credit union assumed the liability and the quality of eligible collateral indicate that the recoverable amount is equal to or higher than 10% and lower than 90% of the accounting value of the contingent liability concerned.

(29) Depending on the amount of the estimated recoverable amount of the expected outflow of funds used to settle assumed contingent liabilities, contingent liabilities classified into risk categories B, C and D shall be classified as follows:

- category B shall include contingent liabilities for which it is estimated that the recoverable amount will be equal to or higher than 70% and lower than 90% of the nominal accounting value
- category C shall include contingent liabilities for which it is estimated that the recoverable amount will be equal to or higher than 30% and lower than 70% of the nominal accounting value
- category D shall include contingent liabilities for which it is estimated that the recoverable amount will be equal to or higher than 10% and lower than 30% of the nominal accounting value.

Risk category E

(30) Contingent liabilities assumed for the account of a person whose financial position deteriorated after the contingent liability was assumed, i.e., after a past obligating event occurred, to such an extent that an outflow of credit union funds for the settling of the assumed liability may be expected with certainty and the estimated future cash inflows of the person to which the credit union is exposed and the quality of collateral indicate that the credit union will not be able to recover more than 10% of the amount to which it is contractually entitled shall be classified into risk category E.

Provisions for identified losses on an individual basis for contingent liabilities

(31) Credit unions shall make provisions for contingent liabilities classified into risk categories B, C, D and E in the amount of the difference between their accounting value and the final estimated recoverable amount of the expected outflow of assets used to settle the assumed liabilities.

(32) The amount of provisions referred to in the preceding item shall be entered in the credit union's business books as the expense on provisions in the income statement for the period in which the loss was identified and in balance sheet liabilities as special provisions for identified losses arising from contingent liabilities.

IV PROVISIONS FOR IDENTIFIED LOSSES ON A GROUP BASIS

(33) Credit unions shall make provisions to cover identified losses on a group basis. Identified losses on a group basis are losses that cannot be assigned to individual placements or contingent liabilities, but with regard to which experience has shown that they exist in the credit portfolio or that they may occur as a result of assumed contingent liabilities. Provisions for identified losses on a group basis amount to 1% of the total balance of placements and contingent liabilities classified into risk category A.

(34) Credit unions shall include provisions for identified losses on a group basis on the expenditure side, and record them in business books in separate provision accounts as liabilities. Provisions for identified losses on a group basis based on placements are recorded in credit union financial statements as a deductible item reducing assets, while provisions for identified losses on a group basis relating to contingent liabilities are recorded on the liabilities side of financial statements as other liabilities.

V DETERMINING CREDIT UNION EXPOSURES

(35) Credit unions shall continuously monitor exposures to one person in accordance with the provisions of Article 42 of the Credit Unions Act (Official Gazette 141/2006 – hereinafter referred to as: 'the Act') and the provisions of this Decision. The exposure of a credit union to one person and the persons connected with that person is the sum of all placements and contingent liabilities of a credit union to those persons.

(36) When calculating the exposure indicator referred to in Article 42 of the Act the exposure to one person is reduced by the amounts of placements secured by a cash deposit up to the amount of the deposit.

(37) When calculating the exposure indicator referred to in Article 42 of the Act, exposure is expressed as a ratio to regulatory capital calculated based on the Decision on the solvency ratio of credit unions for the reporting period for which the indicator is calculated.

VI METHOD OF KEEPING AND MAINTAINING CREDIT RECORDS

(38) Credit unions shall ensure that all placement granting procedures are chronologically monitored (from the loan application, loan application analysis, preparation of loan proposal and the monitoring of the quality of the receivable thus established to the final repayment or other form of liquidation) based on adequate and accurate documentation and data.

(39) Credit unions shall keep credit records so that the records contain a general and a specific part.

The *general part* of the credit records shall contain general information about the person to which the credit union is exposed:

- name and surname (name), domicile (head office), debtor address and identification number (MB)
- financial information and documentation on the financial position and the performed analyses of the debtor's financial position
- assessment of debtor's creditworthiness and stability of debtor's future inflows from which liabilities arising from placements are to be settled
- description of developments in the debtor's financial position (based on updated financial information).

The *specific part* of the credit records shall be compiled by the credit union for each placement or contingent liability and shall include at least the following:

- application for granting a loan or contingent liability
- purpose of placement or contingent liability and the period for which the funds are placed or the guarantee is issued
- evidence of amount of regular monthly income, at least for the last three months, counting from the day the application is submitted
- list of guarantors and related information, if any
- amount of receivables and liabilities of the debtor according to maturity
- loan proposal or proposal for assuming a contingent liability
- decision of the credit union's competent body on the granting of the placement or the assuming of a contingent liability
- agreement on a loan, other form of placement or contingent liability
- documentation on loan disbursement
- type of placement or contingent liability and analytic account and individual account where it is recorded in the credit union's business books
- assessment of placement quality with risk category reference and
- other documentation (business correspondence, warnings, requests for enforced collection, submitted lawsuits, etc.).

(40) Credit records shall be kept in an orderly and prompt manner, with a specific person appointed to be in charge of record keeping.

(41) For placements secured by immovable property, additional documentation in credit records shall contain:

- originals of documents on the acquisition of mortgage (or other immovable property rights)
- valuation report confirming and/or substantiating the market value of immovable property offered as collateral
- documents confirming the selling price of property offered as collateral where the loan was granted for the purchase of said property.

(42) For placements or contingent liabilities granted based on a pledge or transfer of ownership of movable property, credit records must contain documents proving the right of the credit union to acquire and/or sell the property to collect receivables based on placements, estimated market value of the property used to secure the placement (or contingent liability) and insurance with an insurance company. The same

procedure must be applied for the property for the purchase of which the placement was granted and which, at the same time, serves as collateral.

(43) The debtor or the beneficiary of funds granted under the placement may be changed provided that the credit union as the creditor agrees with the change. In that case, the credit union shall provide all information and update credit records in accordance with item (41) of this Decision. Where the new debtor offers additional or new collateral to replace the collateral submitted by the previous debtor, credit records are updated on that basis in accordance with item (41) of this Decision.

VII METHOD OF KEEPING RECORDS OF AND MAKING PROVISIONS FOR LITIGATIONS

(44) Credit unions shall, by the regulation referred to in item (4) of this Decision, prescribe in detail the procedures related to the monitoring of litigations conducted against the credit union. Within the meaning of this item, litigations against the credit union mean litigations where the credit union is the defendant, accused party or enforcement debtor and whose consequence, should the credit union lose the litigation, can be an increase in the credit union's liabilities and an outflow of funds for the settlement of these liabilities.

By this internal regulation, the credit union shall prescribe procedures related to the systematic monitoring of litigations conducted against the credit union and the making of provisions for such litigations. Procedures shall contain:

- the manner of keeping records of litigations
- procedures, criteria, time limits for risk assessment and the determining of necessary provisions to cover liabilities that may arise from litigations against the credit union
- manner of reporting on litigations to the management board (report content, persons responsible for the report and reporting frequency, with the reporting period not longer than six months).

(45) The amount of provisions for litigations referred to in the preceding item shall be recorded in business books as costs of provisions for litigations for the period in which the provisions are recognised, and in the balance sheet liabilities as provisions for initiated litigations.

VII METHOD OF KEEPING RECORDS OF FINANCIAL AID DISBURSED TO CREDIT UNION MEMBERS

(46) Credit unions shall adopt a general regulation on the criteria for disbursing financial aid to credit union members based on which it is possible to determine under what conditions and in what amount financial aid was disbursed and to keep records on disbursed non-repayable financial aid.

IX FINAL PROVISIONS

(47) Credit unions shall notify the Croatian National Bank based on this Decision in the manner and within the time limits prescribed by the Decision on supervisory reports of credit unions.

(48) This Decision shall enter into force on the eighth day following its publication in the Official Gazette.

Decision on amendments to the Decision on the classification of placements and contingent liabilities of credit unions and the determining of exposure to credit risk Official Gazette

(Official Gazette 139/2022)

Article 5

This Decision shall be published in the Official Gazette and enter into force on the day the euro is introduced as the official currency in the Republic of Croatia.