

FINANCIAL SECTOR ASSESSMENT

CROATIA

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EUROPE & CENTRAL ASIA REGION VICE PRESIDENCY
FINANCIAL SECTOR VICE PRESIDENCY

BASED ON THE JOINT IMF-WORLD BANK FINANCIAL SECTOR ASSESSMENT PROGRAM

This Financial Sector Assessment (FSA) summarizes the FSAP report for Croatia. The FSAP mission¹ visited Zagreb during the period September 3-14, 2001 and discussed its preliminary findings with the representatives of the Croatia National Bank (CNB) and Ministry of Finance (MoF) on September 14, 2001. The mission also discussed the assessments of observance of codes and standards with relevant government offices and agencies. The draft FSAP report was presented to and discussed with the CNB and MoF during the IMF Article IV mission in May 2002. At that time, an assessment was also made of the legal and institutional arrangements for Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT). The final FSAP report was submitted in November 2002.

A. Macroeconomic Environment

- 1. Continuing economic recovery and an improved balance of payments limit the macroeconomic risks.** The banking system has recovered from earlier difficulties and is now more resilient and can absorb moderate macroeconomic shocks. Nevertheless, a slowdown in economic growth would affect the profitability of the banking sector and the prospects for its further development. A more pronounced deceleration could have adverse effects on small regional banks exposed to specific sectors, such as tourism.
- 2. Despite a worsening external environment, the economy is continuing to grow and inflationary pressures appear muted.** Resumption of credit to private enterprises indicates that business investment is also recovering after several years of

¹ The FSAP team was led by Albert Martinez (World Bank, Head) and S. Kal Wajid (IMF, Deputy Head) and consisted of Tonny Lybek, Robert Price, Marco Arnone, Leo Bonato (all IMF), Roland Hopfer (Oesterreichische National Bank), Antonio Scalia (Bank of Italy), William Davis (Reserve Bank of Australia), Mario Gara (Suspicious Transactions Report Unit, Italy), Robert Keppler, Noritaka Akamatsu, Donald McIsaac, Simeon Djankov, Luc Laeven, Yongbeom Kim (all World Bank).

contraction. The recovery spurred imports in 2001, so that the current account deficit widened from 2.3 percent of GDP in 2000 to 3.3 percent in 2001. Stronger performance of tourism supported a marginal improvement in the first half of 2002.

3. **The authorities' liquidity management framework is in place, helping to contain the risks of a systemic liquidity crisis.** A complicating factor in monetary management is the uncertainty in the government's financing operations. While the introduction of the single Treasury account has been an important step, the difficulty in reliably projecting government cash flows and liquidity absorption through Treasury bill auctions hampers liquidity control by the CNB. Further efforts are needed to improve planning, monitoring, and forecast accuracy of the government's cash flows. More effective coordination between the MoF and CNB will be essential in moving toward a system of indirect monetary control.

4. **There is a need to further develop other instruments of monetary policy to enhance the transmission mechanism and foster the development of interbank and secondary markets.** Auctions of CNB and Treasury bills should be streamlined and coordinated with a view to enhancing day-to-day liquidity management. Detailed recommendations in this regard have been provided by the Fund's December 2001 technical assistance mission.

5. **The debt management strategy and framework should be enhanced to better assess and manage risks.** While the MoF has recently made efforts to improve the public debt management framework, it should be strengthened further by broadening the possibilities for borrowing in different instruments without compromising fiscal discipline. The functioning of the primary government securities market could be strengthened in view of the impending introduction of new pension funds and long-term government bonds. Development of the domestic long-term government securities market can be helpful, since the government's borrowing requirement is expected to remain substantial.

B. Banking

Structure and Performance

6. **Croatia has made substantial progress in restructuring its banking system since the banking crisis of 1998/99.**² At mid-2002, banks with majority foreign ownership controlled more than 85 percent of the banking system's assets. Two banks remain state-owned, with Hrvatska Poštanska Banka (Postal Bank) in need of reorganization in the short term. The Government should consider the longer-term

² A significant segment of the Croatian banking system came under stress in 1998/99 when several banks turned out to be vulnerable to adverse macroeconomic developments. The crisis exposed weaknesses in risk management, substantial related party lending and single client exposure, inadequate provisioning and political interference in lending decisions in a system dominated by public sector banks.

options for privatization of the Postal Bank. There are many small privately-held banks that play an important role in certain regions within the country. With continuing consolidation, many of the smaller banks are likely to become niche players, merge, or exit. To avoid fiscal costs related to failure of some of the smaller banks and improve the overall efficiency of the system, firm actions must be taken against breaches of minimum capital requirements.

7. **Further consolidation of the banking sector is expected.** Croatian banks are small by international standards. While this should be seen in light of Croatia's GDP per capita, further consolidation of the industry may be necessary to realize economies of scale and undertake the investments necessary to increase efficiency and maintain competitiveness. The limited scale of operations suggests that efficiency of banks may lag that in other transition countries such as Poland and the Czech Republic.

8. **Performance indicators and growth in deposits suggest a substantial improvement in the profitability and health of the banking system over the past three years.** This reflects an improvement in the underlying business environment as well as the cleanup of bank balance sheets following the banking crisis. Improved profitability, exit of some insolvent banks, recapitalizations, and regulatory changes contributed to higher capital adequacy ratios by end-2001. Nonperforming assets declined from 10 percent of total assets at end-2000 to 7 percent at end-2001. However, asset quality varies among institutions, and nonperforming loans remain high for certain banks.

9. **The banking system is relatively well capitalized.** As of end-2001, the system reported an average risk-weighted capital adequacy ratio of 18 percent compared to a statutory ratio of 10 percent. The definition of the capital adequacy ratio is broadly consistent with international practices, but as in many emerging markets, the ratio solely reflects credit risk and does not incorporate market risks.

10. **Bank restructuring in the aftermath of the 1998-99 banking crisis temporarily impeded financial intermediation,** which has picked up more recently with both deposits and loans showing strong growth. The degree of financial development, as indicated by the ratio of private credit to GDP (40 percent), appears low by European standards. Some banks continue to place large amounts of foreign currency deposits at foreign banks, because credit risk domestically remains substantial and some banks are still undergoing internal restructuring. There was substantial credit growth both to households and to enterprises since the banking crisis.

11. **To foster a higher level of financial intermediation, it is important to strengthen the framework for loan and collateral recovery.** At present, recovering collateral involves a very cumbersome process that deters banks from financing creditworthy investment projects. Land registration is subject to long delays and there are

severe practical difficulties associated with the registration and enforcement of pledges concerning movable property, such as receivables and inventories. The problems with the registration of both movable and immovable property reduce the value of such collateral and, therefore, lower the scope for financial intermediation and increase its cost.

12. **The development of a credit information database can contribute to greater financial intermediation.** So far, there is limited information available on borrowers' credit history and financial position. Bank's secrecy requirements should not be a deterrent for the development of such a database, which should include both positive and negative information on borrowers. Timely reporting for this database must be made mandatory for the banks and all other types of lending institutions, and access to the database should be open to all participants.

13. **The profitability of the Croatian corporate sector has improved significantly in the past year but rapid loan growth to this sector deserves close monitoring.** Large parts of the corporate sector, in particular the SMEs, may find themselves in distress in the event of a significant change of the exchange rate. While banks report large loans (HRK 5 million and above) to the CNB and information about the aggregate exposure is made available to banks, an inadequate credit information infrastructure, difficulties in evaluating lending opportunities and weaknesses in arrangements in the realization of collateral warrant caution against rapid growth in bank loans to the enterprise sector. Credit scoring systems are only now being implemented even in the most advanced banks and it would take time for them to function effectively, especially in smaller regional banks.

Vulnerabilities

14. **Overall, the banking system is primarily exposed to risks stemming from macroeconomic policies and adverse external exogenous shocks, since these developments are likely to have the most significant effect on credit quality through exchange rate fluctuations.** Banks' direct exposure to exchange rate risk is limited. The expansion of bank credit deserves closer monitoring with credit growth in excess of 15 percent per year.

15. **Most of the largest banks are less exposed to other risks, including interest rate, equity price, and liquidity risk,** although there are significant differences among the individual banks. Based on partial information on repricing mismatches of credits, and deposits and borrowings, current profits can absorb the effect of minor interest rate changes for most banks. Banks are also exposed to liquidity risk, both in kuna and foreign exchange, but the requirement to maintain at a minimum 53 percent of foreign currency liabilities with a maturity of less than one year in short-term foreign exchange claims, helps in reducing these risks. The case of the Rijecka Banka, which experienced a run in March 2002 due to fraudulent foreign transactions, indicates the need for greater attention to operational risk.

16. **CNB should consider implementing more risk-based supervision and further strengthening of the supervisory information gathering and analysis.** This would include developing a framework for regular stress testing, collection of detailed information on credits to different sectors and about largest depositors, and credit reporting system for small borrowers .

C. Payments System

17. **In collaboration with other relevant government agencies, the CNB has launched two substantial initiatives in the payments area.** These are: (i) the installation of a modern real-time gross settlement (RTGS) system to process all large value and time critical transactions with intra-day legal finality; and (ii) the installation of a multilateral net settlement system—the National Clearing System (NKS)—to process low value transactions with provisional intra-day periodic settlement and end of day legal finality. Both of these systems are considered to be of systemic importance and have their legal foundation in the *National Payments System Law*.

18. **Full implementation of the NKS system ensures that the core payment systems in Croatia are generally compliant with best international practice for safety and soundness.** The low value NKS system supports the transfer of responsibility for maintaining and operating customer transaction accounts to the commercial banks as of February 2002. Although the NKS system has been designed to accommodate both credit and debit transfers, its initial operations are limited by law to processing only credit transfers. Provisional settlement will take place on a continuous basis throughout the operating day; but final legal settlement will be accomplished through the HSVP system at the end of each operating day in funds at the CNB.

D. Securities Markets and Non-Bank Financial Institutions

Capital Markets

19. **While the basic legal and regulatory framework for securities markets was established in 1995, it requires updating and enhancement.** The mission found that several relevant pieces of legislation lacked clarity and provided insufficient authority to CROSEC. Since the mission, these pieces of legislation were updated. The passage of the *Securities Law* was a step towards strengthening the legal framework, although there remains room for further enhancements. In addition, three other laws—the *Law on Investment Funds*; the *Law on Privatization Investment Funds*; and the *Law for the Takeover of Joint Stock Companies* —were amended to more clearly define certain key concept such as securities, public offering, and publicly held companies and to bolster CROSEC's autonomy.

20. **Amendments to the *Company Law* have been drafted to address weaknesses in corporate governance.** Draft changes to the *Company Law* would amend provisions that allow company charters to include *vinkulacija*, or restricted share transfer, for which

company management approval is required prior to the legal transfer of shares. In the draft law, no traded companies would be permitted to include *vinkulacija* in their charters and thus the shares would be freely transferable, as recommended under the OECD Principles of Corporate Governance.

Insurance Sector

21. **The insurance sector is small and concentrated.** Premiums collected are about three percent of GDP, compared to a range of six percent to eight percent in Western Europe. The market structure is somewhat distorted, with the state-owned Croatia Osiguranje capturing a 51 percent market share, and the balance of the market being divided among 26 other privately owned companies. Croatia Osiguranje is slated for privatization in the near future. The ten majority foreign-owned insurance companies have an aggregate 25 percent stake in the domestic insurance market.

22. **Legislation applicable to insurance companies and regulations issued by the Insurance Companies Supervisory Agency (ICSA) have been updated several times in recent years and now conform in many respects to the system prescribed for companies in the European Union.** However, the ICSA needs to be strengthened considerably. Supervision work is carried out by a small professional staff in the ICSA, but because of limited resources it is unable to enforce the regulations aggressively, and on-site inspection of companies is rare. A more hands-on approach to supervision emphasizing risk management analysis is required to ensure uniform regulatory compliance as well as address potential problems. In addition, there can be no real confidence in supervisory analysis without regular onsite inspections to confirm that data are correct and that audit reports are as sound as they should be. There is a pressing need for staff with actuarial skills.

Pension Funds

23. **The legal framework for pension funds is based on sound principles although there are some areas where it could be strengthened.** First, amendments introduced to the law in 2000 weakened the independence of the pension fund supervisor HAGENAS and its governance structure. Second, the legislation sought to establish a rigorous licensing regime, but prescribed too short a deadline for reviewing documentation and issuing the license. Third, the law's overly stringent requirements on custodians might exclude some of the most qualified banking institutions from providing custodial services.

24. **As capital markets develop, the current legislation setting quantitative limits on investments in different assets classes could be relaxed, particularly the provision that at least 50 percent of assets be invested in public debt securities.** This provision could make pension funds a captive source of savings for the public sector and limit the diversification of retirement savings between the public and private pillars. Foreign

diversification is capped at 15 percent of assets, a major restriction considering the modest size of the domestic market. Permitting greater foreign diversification and including provisions in the regulation of the investment regime that exclude Croatian public debt traded overseas from the foreign asset category are recommended.

25. **To protect workers from imprudent or risky asset management, the second pillar comprises a guarantee on returns, financed first by the administrator and the shortfall by the government.** The benchmark triggering the guarantee needs to be better defined. In the short run, the benchmark is not likely to create distortions since portfolios are projected to be similar across pension funds due to the limited supply of securities. In the longer term and with more investment choices available, however, a stringent benchmark that severely penalizes deviations from the rest of the pension fund market will encourage mimicking of portfolios and dampen competition. The period for measuring performance should be expanded from one year, as determined in the current law, to at least a three-year moving average. Expanding the measurement horizon will reduce the penalty on pension fund administrators for short-term deviations and allow greater flexibility in their investment choices.

E. Crisis Management, Deposit Insurance, and Bank Rehabilitation

Early Warning Systems and Lender of Last Resort

26. **Considerable efforts have been made to analyze and develop early warning (EWS) and financial soundness indicators (FSIs).** The CNB's EWS tracks banks offering excessive interest rates on deposits, and indicators of banks' kuna and foreign exchange liquidity, which historically have proved to be good leading indicators. The CNB also monitors a set of FSIs, including nonperforming assets, specific provisions, aggregate large exposures, deposit and credit growth, net foreign assets, liquidity, and profitability indicators.

27. **The lender-of-last resort function through the provision of short-term liquidity loans is clearly defined in CNB regulations.** The regulations provide that such loans can only be granted to solvent banks experiencing liquidity problems and in situations where the CNB considers that the stability of the financial system is threatened.

28. **From early 2001 to March 2002, the lender-of-last resort facility has not been used, but it was activated to provide liquidity support to Riječka Banka as it experienced a run after disclosure of large foreign exchange trading losses.** The requirements concerning the use of the facility are appropriate and should be firmly adhered to in order to avoid moral hazard. The CNB's increased autonomy, the prompt correction framework included in the *Banking Law*, and the increased ownership by foreign banks sensitive to reputational risk should increase the likelihood of timely actions and avoid a repeat of previous problems that required significant government support.

Deposit Insurance and Bank Failure Resolution

29. **The handling of the recent Riječka bank episode attests to the effectiveness of bank safety net and resolution arrangements.** Nonetheless, consideration should be given to reviewing the role and structure of the Agency for Deposit Insurance and Bank Rehabilitation (DAB), which was established in 1997 to both insure savings deposits and assist in restructuring and rehabilitating banks. Since the rehabilitation of banks is almost completed, its mission would require re-evaluation. In addition, there should be a review of the coverage and pricing of deposit insurance. The current coverage of HRK 100,000 per depositor in combination with a deposit insurance premium of 0.8 percent per annum seems high by international standards and is perceived as a significant tax on the intermediation process.

30. **A clear division of responsibilities and an improvement in the coordination between the CNB and the DAB is needed to avoid conflicts of interest and to achieve the objective of bank failure resolution at “least cost.”** Coordination needs to extend to all levels within the CNB (especially its supervision division) and the DAB. All institutions involved should adhere to firm rules and have clear objectives.

F. Unification of Financial Supervision

31. **Consideration of a single unified supervisory agency seems premature at this stage.** A unified regulatory structure has been adopted by relatively few countries as designing the appropriate institutional structure for regulating financial activities involves a host of factors, including the nature and complexity of regulated institutions and markets and the degree of the linkages among them. Croatia’s circumstances do not seem suitable for a unified agency, although some adaptation of the existing arrangements may be needed in view of the further broadening of financial activities and weaknesses in some areas. Regardless of the choice of the regulatory structure, it is most important to ensure that the conditions for effective supervision are in place with adequate coordination among the regulatory bodies.

32. **There are compelling reasons for maintaining the responsibility for banking supervision with the CNB.** The CNB has made significant progress since the mid-1990s and is continuously improving its supervision of commercial and savings banks. The autonomy and accountability of the CNB and stature were further strengthened with the adoption of the *Law on the Croatian National Bank* in April 2001. The CNB also has easy access to resources in the event it is necessary to address urgent problems and to further strengthen supervision of the banking sector. Under the current circumstances, these achievements would be compromised by removing banking supervision from the CNB. The objectives of ensuring price stability and maintaining a sound financial system are mutually consistent in the medium term. Nevertheless, it would be important to enhance consolidated supervision and coordination between the various supervisory

agencies to facilitate effective supervision of the various banking groups and emerging financial conglomerates.³

G. Legal Framework for Secured Transactions and Insolvency

Debt Recovery for Secured Transactions

33. **The recovery of overdue debt and claims of secured creditors is slow, and judicial procedures are cumbersome.** Commercial bankers have identified these problems as major constraints on the expansion of long-term corporate lending. While the problems of clogged courts and slow resolution of claims are faced by all transition economies reforming their legal systems, they are particularly acute in Croatia. The recovery process for small debts takes less than a year in Latvia and Romania, and about 18 months in the Czech Republic, Hungary, Poland, and Slovakia. In France, Germany, and Greece, it takes less than a year for creditors to collect on overdue debt. In Denmark, the Netherlands, Norway, and Sweden, it takes six months or less. The pace of litigation in Croatia is the slowest among transition economies, and among the slowest in a survey sample of over 100 countries.

34. **As a civil law country, Croatia does not have specialized commercial courts present in many other countries, including some transition economies.** As a result, commercial cases compete with all other cases for judges' time. A comprehensive review of the processes and institutions dealing with commercial dispute resolution, including the structure and capacity of the courts, is needed.

35. **Land registration is subject to long delays, and practical difficulties persist regarding registration and enforcement of pledges over movable property.** The delay in the registration of pledges has resulted in an unreliable register, encouraging the banks to take on additional collateral of up to three times the loan amount. The severe practical difficulties associated with the registration and enforcement of pledges over movable property, such as receivables and inventories, render the effective value of such collateral negligible. As a result, Croatia is lagging behind other modern financial systems with these problems lowering the scope for and raising the cost of financial intermediation.

Insolvency

36. **Croatia's relatively new bankruptcy system, like many in the region, has shortcomings.**⁴ Inexperience and the paucity of training among judges and trustees,

³ In the event of problems in a financial conglomerate, there should be an agreement regarding the "lead" regulator.

⁴ The *Croatian Bankruptcy Law*, which closely follows Germany's new bankruptcy law, came into force on January 1, 1997, faced implementation problems immediately, and was amended in 1999.

mismatches with other laws, gaps in the legal framework for insolvency, and lack of transparency and accountability remain important sources of problems. Creditor distrust is based on alleged corruption and collusion among judges and trustees. The current structure of the bankruptcy council, with its three judges as well as a bankruptcy judge in the case, is inefficient. There are no specialized judges, and few commercial court judges have expressed an interest in specializing in bankruptcy due to problems and public pressure, which are more acute in regions outside the main cities.⁵

37. **Inefficiencies due to unqualified trustees have been improving in recent years with the passage of new professional rules and testing requirements for qualification.** The Ministry of Justice has begun to weed out many of the poorly skilled trustees. Previously, there were about 680 trustees; since the introduction of the examination, only 180 of the approximately 600 candidates have been certified.

38. **Enterprise rehabilitation or reorganization rarely occurs and there are few incentives for creditors to make this work.** Secured creditors interested in recovering collateral have a lower priority than employee claims, which are treated as an administrative expense. This prioritization offers little incentive for employees to support a reorganization plan when back wage and severance claims are large.

Accounting and Auditing

39. **Croatia has adopted International Accounting Standards (IAS) and International Standards on Auditing (ISA) for all companies and audits.** However, facing a growing perception that the IAS are too burdensome for SMEs, changes to the Accounting Law (which is under review as part of the EU convergence process) may be suggested that would introduce a form of simplified reporting for such enterprises. This should be done only as part of a harmonized European and/or international approach to SME reporting, and only in compliance with the *acquis communautaire*.

40. **Although there is no “standards gap,” informed observers appear concerned that there is a significant “compliance gap.”** Croatia has gone further and faster than many of its Southern and Eastern European neighbors in reforming its legislation, but actual practices do not always comply with these requirements. In part, this is due to lack of demand-driven pressure given the small number of listed companies in the stock market, the use of other information sources for trade and bank credit decisions, a lack of experience and expertise on the part of users, and difficulties of access to audited financial statements. In addition, there is no oversight of auditors to ensure the quality of their work.

⁵ For example, in the Zagreb Commercial Court, there are 57 judges all responsible for bankruptcy proceedings. The MoJ has prescribed norms for being designated as a specialized judge. These norms are apparently too high for most judges to qualify.

H. Anti-Money Laundering

41. **A legal framework and enforcement procedures for the prevention of money laundering are in place.** The *Law on Prevention of Money Laundering*, based on the Financial Action Task Force (FATF) recommendations and the relevant EU Directive, was adopted in 1997 and amended in 2001; other pertinent legislation is also in place. Banks are obligated to report any suspicious transactions to a special financial intelligence unit at the MoF. During its onsite inspections, the Banking Supervision Department of the CNB reviews banks' procedures and reports suspicious transactions to the special unit in the event that the bank has not already done so.

42. **The *Law on Prevention of Money Laundering* covers a wide range of institutions.** Other supervisory authorities in the securities and insurance areas and institutions such as exchange offices, pawn shops, and gaming houses are required to report suspicious transactions and to ascertain the identities of parties involved in transactions exceeding HRK 105,000.⁶ The special intelligence unit can also stop a suspicious transaction for a short period of time, and has the authority to do its own onsite inspections in pursuit of suspicious activities. Procedures have also been put in place in the payment systems to track suspicious payments. The FATF reviewed Croatia in 2000 and determined it to be a cooperative jurisdiction.

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44. World Bank User

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⁶ The Customs Service is required to send notification to the MoF regarding the legal transfer or any attempt at legal transfer across state borders of cash or checks in domestic or foreign currency amounting to HRK 40,000 or more.