

**Republic of Croatia: Financial System Stability Assessment,
including Reports on the Observance of Standards and Codes on
the following topics: Banking Supervision, Payments Systems,
Securities Regulation, Insurance Regulation,
and Monetary and Financial Policy Transparency**

This Financial System Stability Assessment paper on the **Republic of Croatia** was prepared by a staff team of the International Monetary Fund and the World Bank as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **July 25, 2002**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the Government of the **Republic of Croatia** or the Executive Board of the IMF.

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REPUBLIC OF CROATIA

Financial System Stability Assessment

Prepared by the Monetary and Exchange Affairs and European I Departments

Approved by Stefan Ingves and Michael Deppler

July 25, 2002

- This Financial System Stability Assessment report is based primarily on two visits to Croatia, during April 23–27 and September 3–14, 2001, as part of the joint Bank-Fund Financial Sector Assessment Program (FSAP). The FSAP findings were discussed with the authorities during the Article IV consultation mission in May 2002. Developments until then have been reflected in this report to the extent possible. At the time of the Article IV mission, an assessment of the legal and institutional framework for anti-money laundering and combating financing of terrorism was also undertaken.
- The FSAP team was led by Messrs. Albert Martinez (World Bank, Head) and S. Kal Wajid (IMF, Deputy Head) and comprised Messrs. Tonny Lybek, Robert Price, Marco Arnone, (all MAE, IMF), Mr. Leo Bonato (EU1, IMF), Mr. Roland Hopfer (Oesterreichische National Bank), Mr. Antonio Scalia (Bank of Italy), Mr. William Davies (formerly with the Reserve Bank of Australia), Mr. Mario Gara (Anti-Money Laundering Department, Suspicious Transaction Reports Unit, Italy), Messrs. Noritaka Akamatsu, Robert Keppler, Donald McIsaac, Simeon Djankov, Luc Laeven, Yongbeom Kim (all World Bank), and Ms. Jacqueline Pentz-Greene (MAE, IMF). The FSAP team met with senior officials of the Croatian National Bank, including Deputy Governor, Mr. Boris Vujčić, Vice Governor, Mr. Tomislav Presečan and Vice Governor, Mr. Cedo Maletic; Assistant Minister of Finance, Mr. Miljenko Fičor, Assistant to Minister of Finance, Mr. Hrvoje Radovanić; senior officials of other governmental agencies; and representatives of the private sector.
- The financial system is now more resilient and seems better prepared to cope with moderate shocks. The larger banks are generally better capitalized and their risk management capacity has improved. The economy, however, remains highly euroized and susceptible to shifts in residents' sentiments toward the local currency, so that severe macroeconomic shocks can cause difficulties for banks by straining the debt servicing capacity of borrowers. Banking supervision is being further strengthened by moving toward a more risk-based approach. The nonbank segments of the financial system are relatively less developed and do not pose major systemic risk, but there are considerable weaknesses in their supervisory and regulatory infrastructure.
- The main authors of the report are Messrs. S. Kal Wajid, Tonny Lybek, Leo Bonato, and Marco Arnone.

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ACRONYMS

BSD	Banking Supervision Division of the Croatian National Bank
CAR	Capital adequacy ratio
CNB	Croatian National Bank
CNB Law	Law on the Croatian National Bank
CPSIPS	Core principles for systemically important payment systems
CROSEC	Croatian Securities Commission
DAB	State Agency for Deposit Insurance and Bank Rehabilitation
DC plans	Defined contribution pension plans
DVP	Delivery-versus-payment
EU	European Union
EWS	Early warning system
FATF	OECD's Financial Action Task Force
FINA	Financial Agency
FIU	Financial Intelligence Unit
FSI	Financial Soundness Indicators
HAGENAS	Pension Fund Supervisory Agency
HSVP	Croatian Large-Value Payment System
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
ICSA	Croatian Insurance Companies Supervisory Authority
IOSCO	International Organization of Securities Commissions
ISA	International Standards on Auditing
MoF	Croatian Ministry of Finance
MoJ	Croatian Ministry of Justice
MOU	Memorandum of Understanding
NKS	National Clearing System
OTC	Over-the-counter market
REGOS	Central Registry of Insured Persons
ROA	Return on assets
RTGS system	Real-Time Gross Settlement System
SDA	Croatian Central Depository Agency Inc.
SME	Small and medium-sized enterprises
SOE	State-owned enterprises
VSM	Varaždin Over-the-Counter Market
ZAP	Domestic Payment Agency
ZSE	Zagreb Stock Exchange

SECTION I. STAFF REPORT ON FINANCIAL SECTOR ISSUES

I. OVERALL STABILITY ASSESSMENT

- 1. Croatia's financial system is now more resilient and can absorb moderate macroeconomic shocks.** The potential for macroeconomic instability from shocks to the financial system is also contained. The systemically important banks are now better capitalized, their operations are on sounder footing, and interbank exposures among them are limited. At the same time, the economy remains highly euroized and susceptible to shifts in residents' sentiments toward the local currency, so that severe macroeconomic shocks can cause difficulties for the banking system by straining the debt servicing capacity of borrowers in domestic and foreign currency.
- 2. The majority of banks are well capitalized, but they may be vulnerable to a sharp deterioration in credit quality, either directly, or indirectly through significant exchange rate changes.** Sensitivity analysis indicates that an increase in credit risk—possibly due to a fall in tourism or manufacturing activity—resulting in losses amounting to almost 10 percent of risk-weighted assets would breach the statutory capital requirements of the banking system, with the least capitalized bank of the ten largest banks becoming insolvent.
- 3. While market and interest rate risks seem limited, banks' attention to operational risk needs to be heightened, as demonstrated by the recent run on Riječka Banka.** The failure was precipitated by fraudulent hiding of trading losses which were not unearthed in time by the bank's internal control systems, external auditors, or the bank examination process. The experience, however, also showed that the lender of last resort and crisis management arrangements worked well so that the crisis was quickly contained. A new owner has been found who will recapitalize the bank.
- 4. The mission assessed that compliance with the Core Principles for Effective Banking Supervision is fairly high.** Overall banking supervision is sufficiently strong, although consideration should be given to greater risk-based supervision and to strengthening the supervisory information base and analysis, including regular stress testing. Supervision on a consolidated basis, allowance for market risk in capital adequacy calculations, and agreements with foreign supervisory agencies are also areas that deserve attention. Some of these concerns are likely to have been addressed in the recently adopted *Banking Law*.
- 5. The potential for settlement risk is limited and significant reforms have been implemented to modernize the payment systems.** The observance of the Core Principles for the two systemically important payment systems—the Large Value Payment System and the National Clearing System—assessed is high, although there are minor deficiencies, particularly regarding the location of backup facilities at a remote secondary site.
- 6. Ongoing structural reforms in the financial sector are essential for greater financial deepening and efficiency as well as in pacing capital account liberalization.** Considerable efforts are underway in harmonizing legislation, regulations, and practices with those in the EU. Progress has been made in strengthening banking supervision, although

there are weaknesses in legal and judicial processes—including the institutional framework for secured transactions—which impede longer-term financial intermediation. There is also scope for strengthening prudential regulations pertaining to banks' net open position to take account of options, including embedded options.

7. **The public debt profile suggests some vulnerability to a sharp depreciation of the kuna, reflecting the heavy reliance on external borrowing.** Being at the lower end of the investment grade rating, a slight change in Croatia's sovereign credit rating could affect the prospects of rolling over external debt. This underscores the importance of a well-elaborated framework and strategy for public debt management to enhance the management of public sector obligations across debt instruments and maturity spectrum.

8. **The authorities are taking steps toward enhancing the transmission mechanism for monetary policy.** The commitment to a stable exchange rate and the high degree of euroization constrain liquidity management and require effective use of the various liquidity management instruments on the part of the central bank. Streamlining these instruments and better coordination between the Ministry of Finance (MoF) and Croatian National Bank (CNB) can contribute to more effective liquidity management and foster the development of money markets.

9. **Capital markets remain underdeveloped with substantial weaknesses in their regulatory infrastructure.** The mission's assessment of the observance of the IOSCO Objectives and Principles found a need for strengthening the powers of the Croatian Securities Commission (CROSEC), clarifying the procedures for inspections and surveillance in the securities business, and better coordination with other regulatory authorities in the financial system. To some extent, these are expected to be addressed by new legislative initiatives.

10. **While the insurance sector does not pose any major systemic risk, it suffers from distortions and supervisory deficiencies.** An assessment of the Core Principles for Effective Supervision established by the International Association of Insurance Supervisors (IAIS) indicates that only 9 out of 17 principles are observed or broadly observed, with important areas of nonobservance. The latter relate to corporate governance, internal controls, on-site inspection, and reinsurance. Given the limited resources of the Croatian Insurance Supervisory Authority (ICSA), the principle on organization of a supervisory authority is judged to be partly observed.

11. **The mission examined the issue of unified supervision and is of the view that consideration of a single unified supervisory agency is premature at this stage.** However, in view of the introduction of pension funds, there is scope for exploiting synergy among nonbank supervisory bodies, but steps in this regard should not impede progress on pension reforms. The mission underscored the need for more effective coordination among the regulatory bodies.

12. **The legal and institutional arrangements for the prevention of money laundering and financing of terrorism show a high degree of compliance with the provisions set out in the April 2002 methodology document.** The deficiencies pertain to the provisions for adequate sanctions and resources and structure of the Financial Intelligence Unit to handle excessive routine reporting of transactions.

II. OVERVIEW OF THE FINANCIAL SYSTEM AND REGULATORY STRUCTURE

A. Structure of the Financial System

13. **Commercial banks are the main financial intermediaries and account for a large share of the total assets in the financial system** (Table 1). A continuing trend toward consolidation of the industry has reduced the number of banks from 60 at the end of 1998 to 43 by mid-2001, with total assets as of June 30, 2001 equivalent to 67 percent of estimated GDP for the year as a whole. In addition, at mid-2001 there were 26 savings banks, four of which are housing savings banks, with total assets accounting for 0.4 percent of GDP.¹

Table 1. Financial System Structural Indicators
(Percent of GDP, unless indicated otherwise)

	1998	1999	2000	June 2001
Deposit money banks				
Number of banks	60	53	45	43
Total assets	67.8	65.3	69.8	67.1
Total loans	41.0	37.7	37.6	37.8
Total deposits	37.4	35.2	41.9	41.4
Share of private sector banks in banking assets (percent)	57.0	54.4	94.0	94.0
Share of foreign banks in banking assets (percent)	6.7	39.9	83.7	84.2
Share of assets of two largest banks	41.0	44.0	47.0	47.0
Savings and housing banks				
Number of banks	33	30	29	26
Total assets	0.1	0.1	0.3	0.4
Total loans	0.1	0.1	0.3	0.4
Total deposits	0.0	0.0	0.3	0.4
Insurance sector				
Number of companies	23	25	27	24
Total assets	4.4	5.3	5.5	5.5
Total premiums	3.0	3.0	2.9	1.6
Capital market (Zagreb Stock Exchange)				
Number of listed companies	6	6	4	4
Number of traded companies	59.0	58.0	60.0	59.0
Market capitalization	13.3	13.5	14.1	14.6
Turnover (as percent of market capitalization)	3.4	2.7	6.9	1.7
Memorandum Item:				
GDP (nominal, millions of HRK)	137,604	142,700	157,511	168,973

Source: CNB

¹ The CNB website (www.hnb.hr) provides detailed information on the structure of the banking system in its new Bank Bulletin publication.

14. **The banking system has been substantially restructured since the banking crisis in 1998/99.**² At end-September-2001, banks with majority foreign ownership controlled almost 88 percent of the banking system's assets. In March 2002, the authorities intervened in the Riječka Banka. A new foreign owner for the bank has been found, and the takeover is about to be finalized. With the privatization of Dubrovačka Banka in early 2002, almost 90 percent of banks' assets is now held by banks with majority foreign ownership. Hrvatska Poštanska Banka (Postal Bank) is in need of reorganization and the Government should consider the longer-term options for its privatization. The remaining privately-held banks are small and do not pose systemic risk, although they play an important role in certain regions within the country.

15. **The progress in bank restructuring and bank privatization has also resulted in increased concentration of the banking market.** Currently, the two largest banking groups account for about half of the assets and deposits of the banking system. Although the level of bank concentration is high by international standards, it does not pose an immediate concern, as the substantial presence of foreign banks and their drive for market share has tended to foster greater price and product competition.

16. **The insurance sector is relatively small and underdeveloped.** At mid-2001, there were 24 insurance companies—most of them sell both life and nonlife insurance products—with total assets equivalent to 5.5 percent of GDP. There are a few leasing companies and savings cooperatives; their size is very small and they are not supervised by the CNB.

17. **The role of the capital market in intermediating savings to productive investment is limited.** The capital market, comprising the Zagreb Stock Exchange (ZSE) and the Varaždin Stock Market (VSM), is not very deep or liquid. As of mid-2001 there were only four companies listed on Quotation I of the ZSE, although 59 shares were traded. Total market capitalization of the ZSE equaled about 14.6 percent of GDP. On the VSM over-the-counter (OTC) market, about 480 shares were occasionally traded during 2000. There were 51 relatively small brokerage companies as of mid-2001.

18. **The pension fund industry is relatively new and began operations in 2002.** In 1998, the Parliament enacted the Pension Insurance Act defining a new three-pillar framework for the pension system: (i) a downsized pay-as-you-go scheme; (ii) a second mandatory fully funded pillar; and (iii) a voluntary fully funded third pillar. A new pension fund supervisory agency, HAGENAS, was recently created to license pension funds. In addition, the Central Registry of Insured Persons (REGOS) has been set up for maintaining records on workers' contributions, fund allocations, and account balances.

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.

B. The Regulatory Framework

19. **The CNB plays a prominent regulatory role because of the importance of banks in the financial system.** The legal framework for banking supervision and regulation is well defined under the *Law on the Croatian National Bank* and the *Banking Law*. The CNB has broad authority for the licensing and supervision of bank operations and for enacting regulations and setting standards for their sound operation. The CNB has discharged this role effectively and has issued prudential regulations that are broadly in line with international practices. The *Law on the State Agency for Deposit Insurance and Bank Rehabilitation* provides for insurance of savings deposits and rehabilitation of banks, while the *Law on the Croatian National Bank*, the *Law on Domestic Payment Systems*, and other legislation establish the framework governing the payment systems.

20. **The *Securities Act* provides the legal framework for regulating primary and secondary markets.** Regulatory authority is vested in the Croatian Securities Commission (CROSEC), which is the main body for enforcing the various provisions of securities legislation, including those related to insider information and market manipulation. Listed companies are required to annually publish audited financial statements and other information essential to investors in evaluating business operations.

21. **The *Insurance Act* and supporting regulations provide the regulatory framework for the licensing, monitoring, and supervision of insurance companies and other intermediaries.** The act defines the responsibilities and powers of the Insurance Companies Supervisory Authority (ICSA), an independent agency that is responsible to the Government. The Director of ICSA is authorized to issue regulations relating to accounting for insurance operations, establish technical provisions to support policyholder obligations, and specify reporting requirements.

22. **The *Law on Mandatory and Voluntary Pension Funds* and the *Law on Pension Insurance Companies* provide the legal framework for regulating pension plans and the pension fund administrator company.**

III. MACROECONOMIC BACKGROUND AND RISKS

A. Macroeconomic Developments and Vulnerabilities

23. **Continuing economic recovery and an improved balance of payments limit the macroeconomic risks.**³ 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

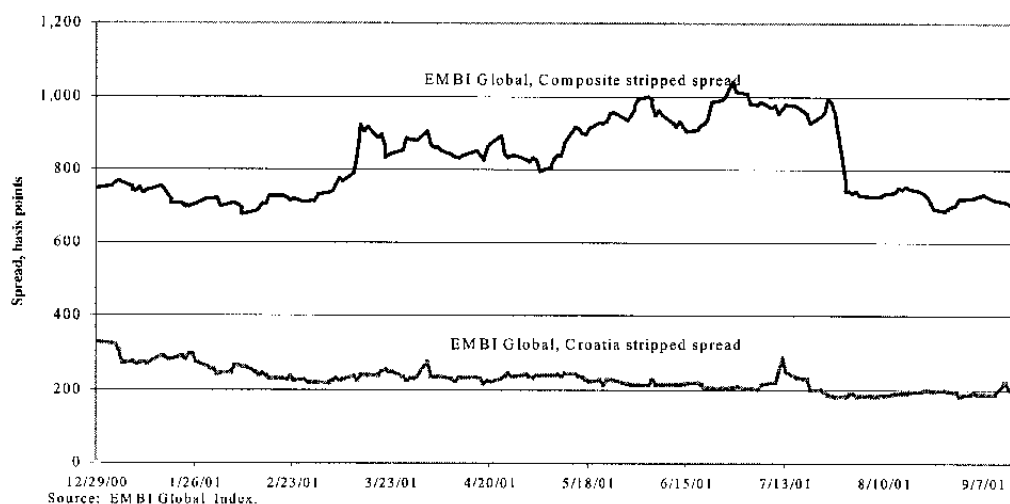
³ Macroeconomic developments are described in detail in the staff report for 2002 Article IV Consultation (SM/02/230, July 18, 2002).

prospects for its further development. A more pronounced deceleration could have adverse effects on small regional banks exposed to specific sectors, such as tourism.

24. **Despite a worsening external environment, the economy is continuing to grow and inflationary pressures appear muted.** Notwithstanding the reduction in the consolidated general government deficit during 2000 and 2001, government debt increased from 49.5 percent of GDP at end-1999 to 52.4 percent of GDP at end-2001. International reserves continue to rise and at end-June 2002 covered about 6 months of imports of goods and nonfactor services and some 200 percent of short-term debt, sufficient to absorb moderate shocks.

25. **International capital markets remain favorably disposed toward Croatian assets, with bond spreads narrowing despite increased volatility in emerging markets financing in 2001 (Figure 1).** Fiscal policy represents the main macroeconomic vulnerability. Given the high proportion of external debt, public sector finances are susceptible to exchange rate risk. Failure to further reduce the fiscal deficit could hinder access to capital markets and engender pressures on the exchange rate.

Figure 1: EMBI Global Spreads, December 29, 2000 - January 23, 2002



B. Liquidity Management and Markets

26. **The authorities' liquidity management framework is in place and the risks of a systemic liquidity crisis are contained.** Nevertheless, the high degree of euroization poses considerable difficulties for the day-to-day liquidity management, limiting the domestic monetary base and requiring prompt adjustments on the part of the CNB. The shifts in the banking system's balance sheet associated with the changes in the *Foreign Exchange Law* in 2001, easing restrictions on the holding of foreign exchange deposits by enterprises, have further complicated this task.

27. **The heavy use of euro-denominated or linked financial assets in the economy means that the kuna-euro exchange rate plays a key role in monetary management.** Euroization is rooted fundamentally in perceptions of political uncertainties ingrained by Croatia's turbulent past and doubts about the capacity of the political process to sustain macroeconomic discipline over the long run. While the pass-through effects of the exchange rate on inflation are not evident in the data, a stable exchange rate is considered important for anchoring expectations and achieving price stability, stipulated in the CNB Law as the main objective of monetary policy.

28. **A situation of structural excess liquidity has been an impediment to the development of the money market and the use of indirect instruments of monetary policy.** The cautious lending policies following the 1998 banking crisis, euroization, an underdeveloped payments system, deficiencies in banks' liquidity management practices and the growth of foreign exchange reserves have contributed to the holding of substantial liquid balances by banks in the form of reserves and placements in CNB bills (Table 2). The use of interest sensitive instruments of monetary policy has therefore not deepened and the CNB has tended to rely on foreign exchange interventions, issuance of its own bills, and adjustments in reserve requirements in affecting domestic liquidity.⁴

Table 2. CNB Accounts
(Millions of kuna)

	Dec. 1999	Dec. 2000	Mar. 2001	Jun. 2001	Sept. 2001
Assets					
Net foreign assets	21,465	27,117	29,317	31,497	34,865
Net domestic assets	-3,251	-5,387	-7,515	-7,869	-7,544
Liabilities					
Reserve money	10,310	11,717	11,346	12,553	13,627
Of which:					
Currency outside banks	5,959	6,637	6,412	7,266	7,475
DMBs' deposits + cash in vaults	4,343	5,073	4,919	5,263	6,135
Other liabilities (including CNB bills)	7,904	10,013	10,455	11,074	13,693
Memo items					
Required reserves	4,210	4,647	4,688	5,109	6,268

Source: CNB Bulletin.

⁴ In response to exchange rate pressures in August 2001, it was decided to require 20 percent of the reserve requirement on liabilities denominated in foreign exchange to be maintained in kuna, to be phased-in in two steps over successive reserve maintenance periods starting on September 8, 2001. The Lombard rate was also raised from 9.5 percent to 10.5 percent. In December, the ratio of foreign currency reserve requirements to be held in kuna was further raised to 25 percent, while the reserve requirement ratio was reduced from 22 percent to 19 percent and the Lombard rate from 10.5 percent to 10 percent.

29. **Another 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.

30. **The CNB has taken a number of steps in the unification of reserve requirements on domestic and foreign currency deposits.** The phased unification of the maintenance currency has limited their liquidity impact and should contribute to greater effectiveness of the CNB's open market and repo operations. Further steps in this connection, however, should be taken after a careful assessment of liquidity conditions to avoid excessive volatility and be announced well in advance.

31. **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 need to be streamlined and coordinated with a view to enhancing day-to-day liquidity management.⁵

32. **The reliance on adjustments in reserve requirements and foreign exchange interventions reflects the limited development of the money and foreign exchange markets.** These markets are characterized by thin transaction volumes, few participants, and market segmentation. Dealers in the money and foreign exchange markets complain that they all too often find themselves on the same side of the market. This results in the need for continued CNB presence, especially in the foreign exchange market.

33. **Some adaptations on the part of the CNB can foster the development of a more liquid and efficient interbank market, although this is likely to be primarily a market driven process.** In this context, an increase in reserve averaging limits, streamlining banks' settlement accounts, and the elimination of any implicit taxation in the form of a lower than risk-adjusted market rate of remuneration on reserve requirements can be helpful. Consideration should also be given to improved communications with markets to provide greater clarity regarding the intentions underlying the CNB's actions.

C. Public Debt Management

34. **The government's borrowing strategy appears to emphasize direct cost and may not adequately take into account the risks.** The public debt profile suggests vulnerability to adverse movements in exchange rates. As of the end of 2001, more than two-thirds of total

⁵ Detailed recommendations in this regard have been provided by the IMF's December 2001 technical assistance mission.

government debt was to external creditors. Croatia is at the bottom of the investment grade in sovereign credit rating, so that even a slight downgrade in its credit rating could affect adversely the prospects for rolling over external debt in the international capital markets.

35. **Development of the domestic long-term government securities market can be helpful, in view of the government's substantial borrowing requirement.** This could proceed in parallel with the introduction of the second pillar pension reform, to reduce reliance on external borrowing and diversify sources of financing. Availability of alternative means of financing may also help limit contagion from adverse developments in emerging markets financing. More generally, the authorities' debt management strategy and framework needs to be enhanced to better assess and manage risks.

IV. BANKING SYSTEM PERFORMANCE AND VULNERABILITIES

A. Indicators of Financial Soundness

36. **Performance indicators and growth in deposits suggest a substantial improvement in the profitability and health of the banking system over the past two years.** Return on assets before tax increased from -2.9 percent in 1998 to 0.9 percent in 1999 and 1.4 percent in 2001 (Table 3). This reflects an improvement in the underlying business environment as well as the cleanup of banks' balance sheets following the 1998-99 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 10.6 percent of total assets at end-2000 to 7.2 percent at end-2001.⁶

37. **While asset quality has improved, it varies among institutions.** The nonperforming assets ratio for the ten largest banks ranged from 2.4 percent to 21.4 percent, of which two banks had a ratio exceeding 15 percent. On average, 90 percent of nonperforming assets represent nonperforming loans. The share of nonperforming loans in total loans declined from 17.6 percent at end-2000 to 13.6 percent at end-2001, while specific provisions decreased from 8.6 percent of total assets to 6.2 percent. The level of nonperforming loans, nevertheless, remains high, especially for some banks.

38. **The banking system is relatively well capitalized.**⁷ As of end-2001, the system reported an average risk-weighted capital adequacy ratio of 18.5 percent (based on unaudited data) 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. This deficiency was expected

⁶ Total assets refer to total assets of deposit money banks as published in the CNB's monthly bulletin.

⁷ As of June 2001, one of the ten largest banks reported a capital adequacy ratio (CAR) was just above the statutory requirement (10 percent).

to have been addressed by the new *Banking Law*. At end-2001, tier I capital accounted for about 9 percent of total liabilities, down from 11.6 percent a year earlier.

39. **The banking system remains rather liquid.** The loan to deposit ratio, a measure of the level of asset transformation, declined after the banking crisis in 1998/99. Prudential measures, including relatively high reserve requirements and the requirement to maintain a certain ratio between a bank's short-term foreign exchange claims and liabilities, also contribute to the relatively high degree of liquidity. In addition to substantial holdings of free reserves with the CNB, CNB bills, and Treasury bills, the banking system also has access to the CNB's Lombard facility, which is used regularly.

40. **Following the resolution of the 1998-99 banking crisis, recourse to the CNB's lender-of-last resort facility has not been common.** In March 2002, when losses due to fraudulent foreign exchange trading activities were revealed at the Riječka Banka, the bank experienced a run on its deposits. The CNB provided the bank with HRK 558 million in lender-of-last resort collateralized loans, which were repaid in early April.

B. Vulnerabilities and Stress Tests

41. **Credit risk, including that resulting from exchange rate fluctuations, is the main systemic vulnerability.** Sensitivity analysis reveals that, assuming immediate provisioning, the two largest banks, accounting for almost half of the assets of the banking sector, would be able to absorb losses of about 5 percent of their respective risk-weighted assets before reaching the minimum statutory capital requirement, while the banking system as a whole would be able to absorb losses of almost 10 percent of risk-weighted assets before breaching this requirement. 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. The expansion of bank credit deserves closer monitoring, as experience of other countries shows that credit growth in excess of 15 percent can result in increased losses.

Credit Risk

Sensitivity analysis points to considerable resiliency of the banking system in absorbing deterioration in credit quality. The following methodology is used to illustrate the impact of an increase in nonperforming assets on the capital adequacy ratio (CAR). Based on end-June 2001 balance sheet data, asset classification, capital base (tier I plus tier II capital), and CARs, adjusted CAR's are calculated for the total banking system and the ten largest banks. The adjusted CAR reflects the impact of moving *risk-weighted* performing assets to nonperforming status, that is, to categories C-E, depending on the degree of provisioning. The minimum specific provision required for an asset classified in category C is 25 percent, while the maximum provision is 100 percent (category E). The change in the status of

Table 3. Croatia: Selected Macro Prudential Indicators,^{1/} 1995–2002
(percent at end of period, unless otherwise indicated)

	1995	1996	1997	1998	1999	2000 Dec	2001 Mar	2001 Jun	2001 Sep	2001 Dec	2002 Mar
Solvency indicators											
Risk-weighted capital adequacy ratio ^{2/}	18.2	17.7	16.4	12.7	20.6	21.4	19.0	18.8	19.2	18.5	...
Leverage ratio, tier I capital in percent of total liabilities	...	13.4	12.0	9.6	11.3	11.6	...	10.7	10.1	9.0	...
Liquidity indicators											
Loan to deposit ratio ^{3/}	129.6	92.6	98.0	107.0	102.5	85.0	85.5	87.6	83.2	71.7	76.9
Banks' reserves in percent of deposits ^{4/}	16.0	13.7	11.1	8.2	8.6	7.7	7.0	7.3	7.6	9.5	10.9
cash in vaults ^{4/}	0.6	0.5	0.5	0.5	0.8	0.8	0.5	0.7	0.5	0.6	0.9
reserves held with the CNB ^{4/}	15.4	13.2	10.6	7.7	7.9	6.9	6.4	6.6	7.1	9.0	10.0
of which required reserves ^{4/}	10.6	10.4	8.7	6.8	7.4	6.2	4.8	4.9	6.0	6.5	7.3
CNB bills on a voluntary basis, percent of deposits	1.0	2.4	1.6	4.3	5.7	6.4	5.8	5.8	6.3	5.4	5.8
Primary liquidity ratio ^{5/}	0.63	2.63	2.92	1.65	1.30	3.32	3.22	2.44	1.16	3.23	3.44
Money market interest rate, weighted daily averages	27.2	10.4	9.4	15.8	12.7	4.5	3.6	2.8	5.4	2.7	2.4
Credit risk indicators											
Total assets, change, yoy	14.7	7.7	26.4	9.4	-0.1	17.9	19.4	20.0	20.0	29.7	26.1
Loans and advances to the domestic private sector, change, yoy	23.5	9.0	48.8	23.9	-6.4	8.9	15.9	20.2	24.6	24.3	23.3
Nonperforming assets, percent of total assets ^{6/}	7.6	9.2	7.2	11.4	11.8	10.6	10.2	9.7	8.5	7.2	...
Nonperforming loans, percent of total classified loans ^{6/}	...	...	...	...	...	17.6	...	15.9	14.7	13.6	...
Specific provisions in percent of total assets ^{7/}	7.9	8.4	6.7	8.1	9.1	8.6	...	8.0	7.2	6.2	...
Foreign exchange risk indicators											
Net open position in foreign exchange ^{8/}	...	...	...	...	34	31	19	6	6	6	16
Net foreign assets in percent of total assets	-9.3	0.1	2.8	-3.7	-5.2	1.7	1.6	-1.0	-0.3	7.7	2.2
Profitability indicators											
Reported return before tax, percent of assets	0.3	0.8	1.5	-2.9	0.9	1.7	...	1.9	...	1.4	...
Spread between lending and deposit rates, kuna ^{9/}	16.2	14.3	9.7	12.0	9.3	7.1	5.4	6.7	6.4	6.8	11.7
in kuna indexed to foreign exchange ^{9/}	6.9	9.5	6.8	5.6	5.9	5.2	4.2	4.5	4.8	4.7	6.4
in foreign exchange ^{9/}	12.6	14.4	8.8	3.0	2.5	4.2	3.5	3.8	3.6	3.3	3.6
Market's assessment of banks											
Deposits with banks, change, yoy	42.8	52.5	40.6	13.6	-2.3	31.2	34.7	29.0	29.1	47.5	37.0
Foreign currency deposits with banks, change, yoy	60.5	54.7	43.4	21.4	-2.6	26.9	28.4	25.7	32.5	53.2	39.9
Intermediation indicators											
Assets in percent of GDP ^{10/}	63.7	62.5	68.9	67.8	65.3	69.8	74.5	68.4	68.7	84.4	87.3
Loans and advances to other domestic sectors in percent of GDP ^{10/}	27.8	27.6	35.9	40.0	36.1	35.6	39.1	36.9	36.7	41.3	44.8
Broad money (M4) in percent of GDP ^{10/}	25.0	34.0	41.0	41.7	39.7	46.4	50.1	46.7	48.5	62.8	63.9

Source: Croatian National Bank; and IMF staff estimates.

1/ Covers deposit money banks. Figures in italics are preliminary.

2/ The significant increase from 1998 to 1999 should be seen in context with the fact that a relatively large number of banks reported negative capital in 1998.

Furthermore, regulation was amended affecting the capital adequacy ratio. The information for 2001 only covers commercial banks.

3/ Loans and advances to domestic sector excluding claims on central government and its funds, in percent of demand, savings, time, and foreign currency deposits, excluding central government and its funds.

4/ Deposits here include demand, savings, time, and foreign currency deposits, but excluding central government and its funds.

5/ The primary liquidity ratio is the percentage of monthly day-to-day free reserves averages on monthly day-to-day averages of deposits which constitute the reserve base.

6/ Nonperforming assets include loans classified in categories C-B in percent of total assets, which here refers to total assets of deposit money banks as published in Table D1 in CNB's Monthly Bulletin. At end-2001, nonperforming loans amounted to 7.8 percent of classified assets.

7/ In addition to specific provisions, banks are required to make general provisions of, at minimum, 1 percent of their assets in category A. Total assets here refer to assets of deposit money banks as published in Table D1 in the CNB's bulletin.

8/ The net open position in foreign exchange was reduced from 30 percent of capital to 25 percent effective December 1, 2000, and to 20 percent effective September 1, 2001, at which time certain exemptions were also abolished.

9/ Weighted averages of monthly interest rates. A change of the maturity structure may thus affect the spread.

10/ Nominal GDP annualized by multiplying quarterly GDP by four.

risk-weighted assets implies a change in the probability—reflecting the risk weights—of moving an asset to nonperforming status.⁸

42. **The analysis reveals that the banking system as a whole would be able to absorb losses of almost 10 percent of risk-weighted assets before breaching the minimum statutory capital requirement.** The latter amounts approximately to an increase in nonperforming assets of 65 percent. Although this is a significant increase, it is noteworthy that from end-1997 to end-1998, nonperforming assets actually doubled due to the banking crisis. If full provisioning is required, a doubling of nonperforming assets for the banking system would amount to about 16 percent of risk-weighted assets being moved to nonperforming status, causing major problems for most of the largest banks.⁹ In practice, however, profits could be a first line of defense to cushion increased provisions, and the impact of the increase may be distributed over time. Banks are also likely to change behavior in an effort to reduce risks.¹⁰

Market and other Risk

43. **Banks' direct exposure to exchange rate risk is limited, but there is considerable uncertainty about the extent of the credit risk stemming from unhedged foreign currency-based borrowing.** The direct effect, estimated by analyzing the net open position, is relatively small for most banks; on average banks have a long position and would appear to benefit from a depreciation of the kuna. The indirect effects of exchange rate fluctuations on the banking system, however, can be considerable because of the widespread use of foreign currency-based borrowing. While it is difficult to quantify the indirect credit risk stemming from exchange rate changes, some illustrative calculations are presented in Figures 3A and 3B. The illustrative calculations indicate that an assumed depreciation or an appreciation in the 15–25 percent range, depending on indicated default and recovery rates, would result in a decline of the CAR of the banking system from 18.8 percent to the 7–12 percent range. Under these assumptions, the changes in the exchange rate can result in serious problems for the least capitalized banks.

44. **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

⁸ Another approach would be to simulate the impact on the CAR of an increase in nonperforming assets. This assumption, based on the average banking system, is indicated on the second horizontal axis in Figure 2. Since the capital base and the level of nonperforming assets are not unequivocally related, the second horizontal axis is an approximation.

⁹ It is noteworthy that a few banks recently have been able to revoke provisions, as they succeeded in recovering more than originally expected.

¹⁰ Smaller banks, in general, appear to be relatively most vulnerable to risk concentration, that is, geographical risk, large exposures, and loans to shareholders and affiliated persons.

for most banks. Banks are also exposed to liquidity risk, both in kuna and foreign exchange, but as previously noted, high reserve requirements, and 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, help in reducing these risks.

45. **This analysis and the assessment of the Core Principles for Effective Banking Supervision suggest that consideration should be given to more risk-based supervision and further strengthening of the supervisory information 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 a credit reporting system for small borrowers.

C. Crisis Management and Safety Nets

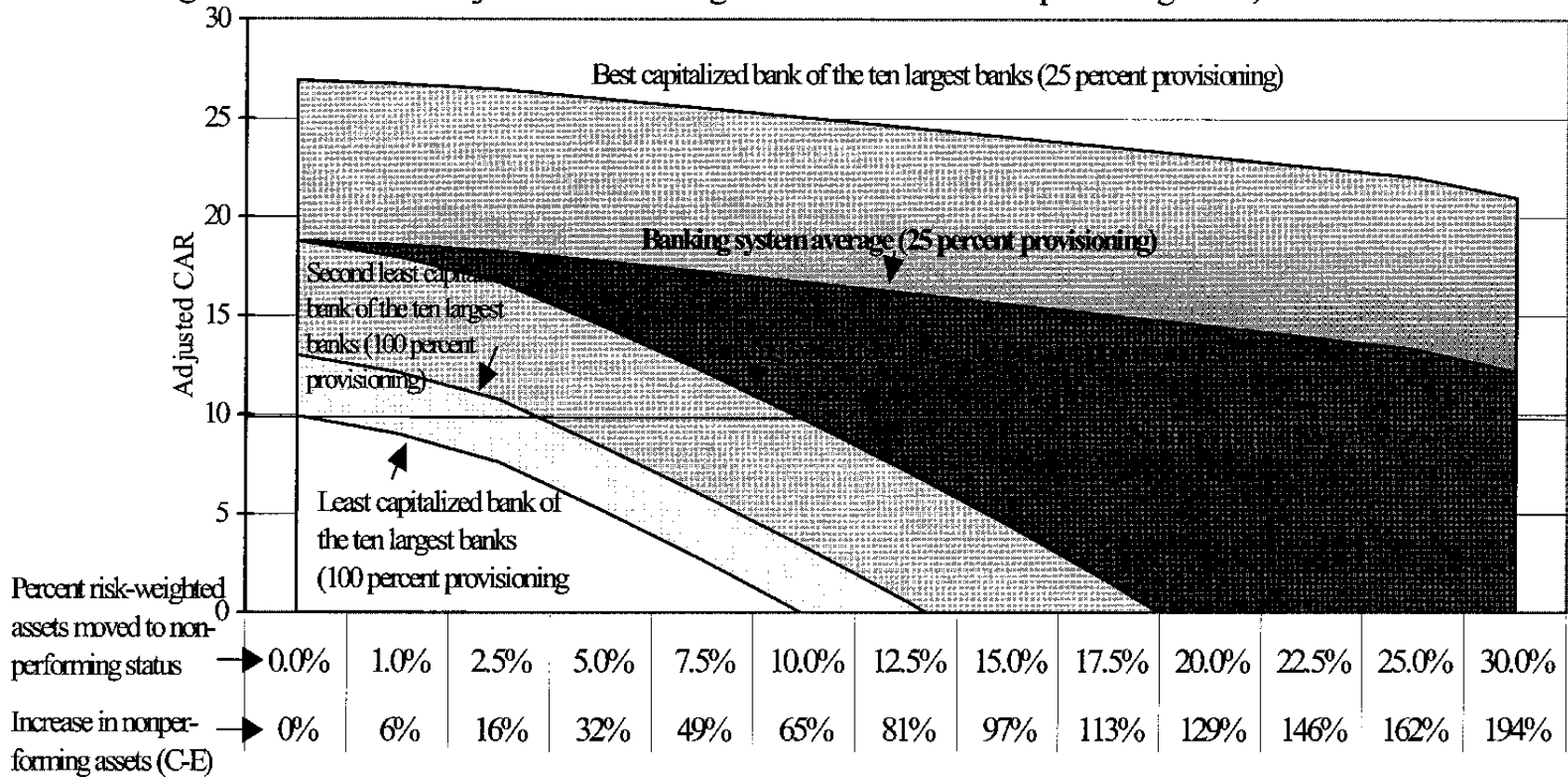
Early Warning Systems and Lender of Last Resort

46. **Considerable efforts have been made to analyze and develop early warning systems (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.

47. **Developments in FSIs indicate significant improvement over the last two years and little change in the situation this year.** According to CNB officials, the Croatian experience suggests that the FSIs tend to coincide with banking crisis and are used to supplement the EWS. The Banking Supervision Department (BSD) is planning to focus on sensitivity analysis in their offsite work and introduce further refinement to the CNB's early warning tools.

48. **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. Liquidity loans must be fully backed by specified collateral, using market value and a haircut for certain collateral. The CNB can accept a broader range of collateral provided that the loan has been requested and guaranteed by the government. The loans must be part of an improvement program agreed with the CNB.

Figure 2. Croatia: CAR Adjusted for Risk-Weighted Assets Moved to Nonperforming Status, June 2001^{1/}



1/ Simulations based on un-audited data as of end-June 2001.

Figure 3A. Croatia: Illustration of Exchange Rate Effects on CAR, June-2001

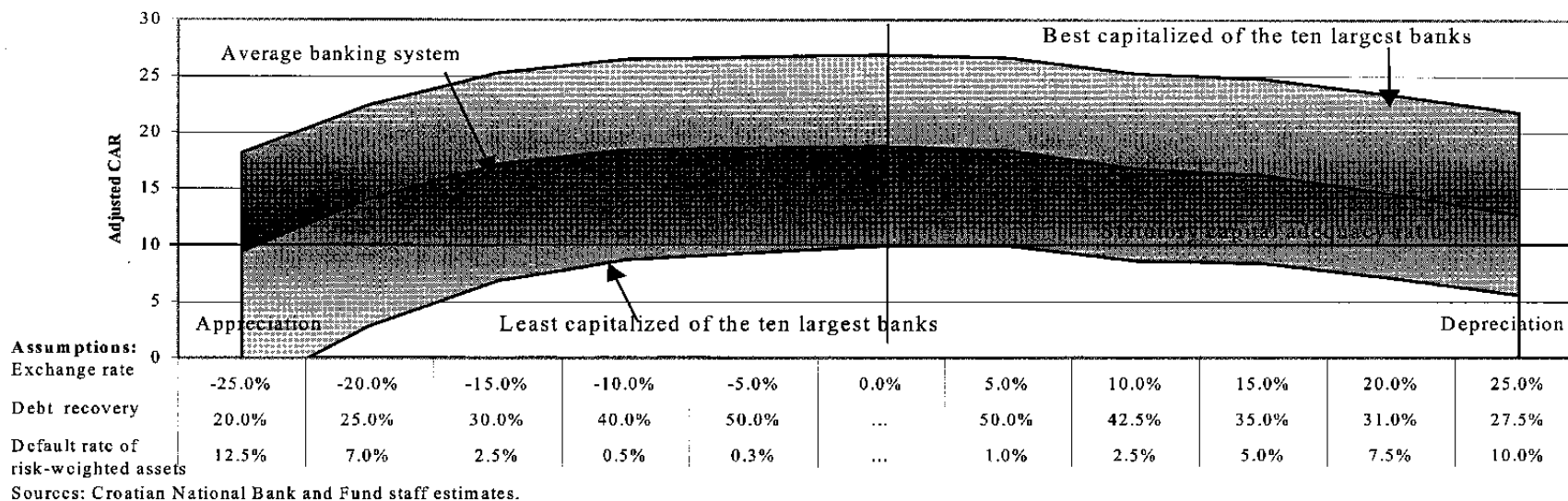
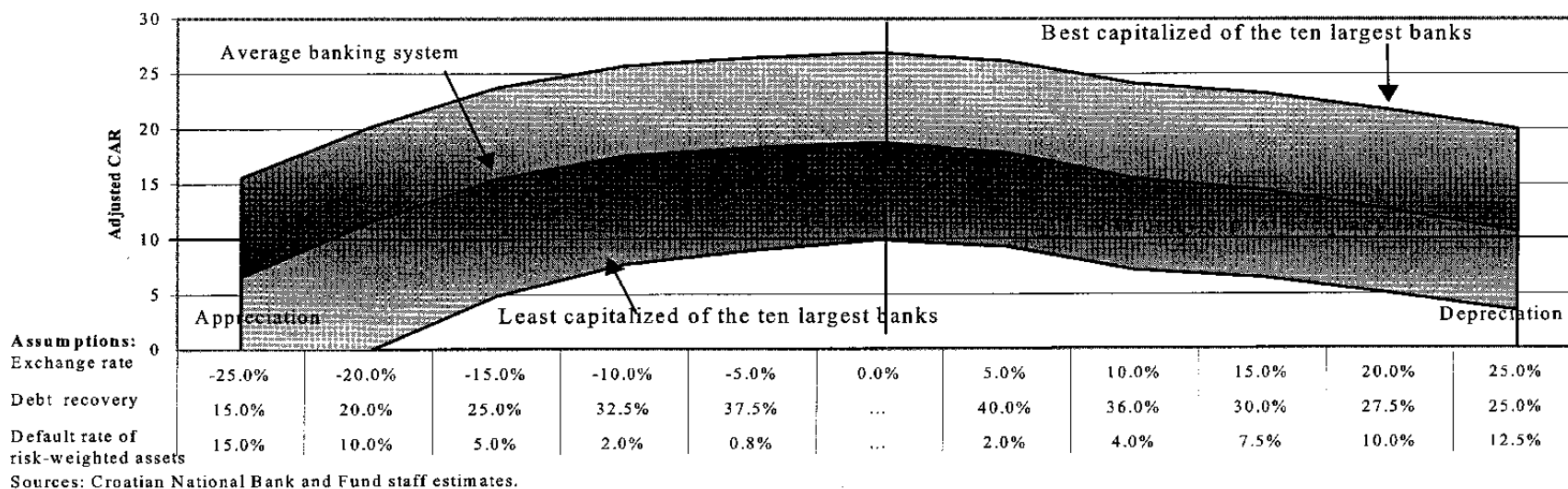


Figure 3B. Croatia: Illustration of Exchange Rate Effects on CAR, June-2001



49. **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 new *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. The presence of foreign banks, however, by itself is not sufficient protection against various risks as demonstrated by the recent Riječka Bank episode

Deposit insurance

50. **The handling of the recent Riječka Bank crisis attests to the effectiveness of bank safety net and resolution arrangements.** Since its inception in 1997, the State Agency for Deposit Insurance and Bank Rehabilitation (DAB), which is responsible for insuring savings deposits and assisting in restructuring and rehabilitating banks, has played a major role in the restructuring and rehabilitation of the banking system. Once the rehabilitation of banks is completed, consideration should be given to a review of the role and structure of DAB, including a review of the coverage and pricing of deposit insurance. The current coverage of HRK 100,000 of savings deposits 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. Disclosure of DAB's externally audited financial statements to the public should also be considered.

51. **A clear division of responsibilities and an improvement in the coordination between the CNB and the DAB are 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.

V. FINANCIAL MARKETS AND NONBANK FINANCIAL INSTITUTIONS

52. **Securities markets remain underdeveloped and play a limited role in the financial system.** As of mid-2001, only 4 companies were *listed* on Quotation I of the ZSE and both market capitalization relative to GDP and turnover as a proportion of market capitalization are low compared to other Central European countries. While the basic legal and regulatory framework for securities markets was established in 1995, it requires updating. The CROSEC's powers regarding inspection, investigation, and surveillance have not been adequately articulated in the *Securities Law*. The new *Securities Law* was expected to have redressed these deficiencies. Under the new legislation banks may engage in the securities business through a separate subsidiary or an in-house unit, which could expand their role in capital markets. Accordingly, there will be a greater need for proper internal control systems within banks and for closer cooperation between CROSEC and CNB.

53. **The insurance sector is small and does not pose a systemic risk to the financial system.** Premiums collected for the year 2000 amounted to 2.9 percent of GDP, compared to 6–8 percent range in Western Europe. Return on assets for the industry as a whole in the

year 2000 is estimated at 0.5 percent. High minimum capital requirements tend to limit the number of new entrants to the industry, thereby limiting competition and maintaining premiums higher than they otherwise would be. Supervision of the industry is carried out by a small professional staff in the ICSA, but because of limited resources the agency is unable to enforce the regulations and conduct on-site inspections. A more hands-on approach to supervision emphasizing risk management analysis is required to ensure uniform regulatory compliance as well as to address potential problems.

54. **The framework for the regulation of pension funds is based on sound principles, although there are some areas where it could be strengthened.** The legislation sets quantitative limits on investments in different assets classes, but as capital markets develop, these restrictions may need to be relaxed, particularly the provision that at least 50 percent of assets be invested in public debt securities. Foreign diversification is capped at 15 percent of assets, a major restriction considering the modest size of the domestic market. Greater foreign diversification (e.g., 25 or 30 percent) is recommended. To protect workers from imprudent or risky asset management, the second pillar comprises a guarantee on returns, financed first by the administrator and then any shortfall by the government. The benchmark triggering the guarantee needs to be better defined as it will affect potential liabilities of pension fund administrators and consequently their portfolio choice.

VI. OTHER ISSUES

A. Unified Supervision of Financial Activities

55. **Consideration of a single unified supervisory agency seems premature at this stage.** 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. As a result, a unified regulatory structure has been adopted by relatively few countries. 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. There may be scope for greater synergy among the nonbank financial supervisory agencies, and consideration might be given to merging the ICSA, the CROSEC, and the HAGENAS. Such an approach could facilitate better coordination and contribute to more effective supervision.

56. **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 its stature were further strengthened with the adoption of the new *Law on the Croatian National Bank* in April 2001. The CNB also has easier 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. 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.¹¹

B. Anti-Money Laundering and Combating Financing of Terrorism

57. **The legal and institutional framework and enforcement procedures for the prevention of money laundering and financing of terrorism show a high degree of compliance with the provisions set out in the IMF's April 2002 methodology document.** Croatia has also criminalized the collection of funds with the intent of carrying out acts of international terrorism. The areas judged to be "materially non-compliant" concern the provisions for sanctions and the resources and governance structure of the FIU in the MoF for effectively carrying out its functions. 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 was amended in 2001, and other pertinent legislation is also in place. Banks are obligated to report any suspicious transactions to the financial intelligence unit at the MoF. During its onsite inspections, the BSD reviews banks' procedures and reports suspicious transactions to the special unit in the event that the bank has not already done so.

58. **The anti-money laundering law 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 105,000.¹² 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.¹³

C. Accounting and Auditing

59. **Croatia has adopted International Accounting Standards (IAS) and International Standards on Auditing (ISA) for all companies and audits.** 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 pressures given the

¹¹ In the event of problems in a financial conglomerate, there should be an agreement regarding the "lead" regulator.

¹² 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.

¹³ See the Ministry of Finance's web-site regarding anti-money laundering measures: <http://www.tel.hr/crofin/>

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.

60. **Substantial changes in the dissemination of audited financial statements are needed.** The lack of user pressures for compliance is not generally compensated for by regulatory instruments, with the exception of the banking sector. Companies under the supervision of CROSEC file unaudited financial statements with the securities regulator, but these appear not to be carefully reviewed. There is little oversight of auditors to ensure the quality of their work. The CNB does receive and review audited financial statements for the banks under its supervision and cross-checks these against information gathered during on-site inspections.

SECTION II: SUMMARY ASSESSMENTS OF THE OBSERVANCE OF FINANCIAL SECTOR STANDARDS

This section of the Financial System Stability Assessment for Croatia contains information on the observance of international standards and codes relevant for the financial sector. The assessment has helped to identify the extent to which the supervisory and regulatory framework is adequate to address the potential risks in the financial system. It also provides an assessment of the transparency practices regarding monetary and financial policy.

As part of the FSAP, the following detailed assessments of standards were undertaken: Basel Core Principles for Effective Banking Supervision: Messrs. Roland Hopfer (Oestertichische National Bank) and Tonny Lybek (IMF); the International Organization of Securities Commission (IOSCO) Objectives and Principles of Securities Regulation: Messrs. Noritaka Akamatsu and Yongbeom Kim (both World Bank); the Committee on Payment and Settlement Systems (CPSS) Core Principles for Systemically Important Payment Systems (CPSIP): Mr. Robert Keppler (World Bank); the International Association of Insurance Supervisors (IAIS) Insurance Supervisory Principles: Mr. Don McIsaac; and the IMF's Code of Good Practices on Transparency in Monetary and Financial Policies; Mr. Marco Arnone (IMF). The assessments were based on the authorities' self-assessments, answers to questionnaires, and work during two FSAP missions in April and September 2001.

Croatia has significantly strengthened financial sector supervision and has enacted relevant laws. Regulations pursuant to these laws have been issued and implementation is generally good in the banking area. Croatia's aspiration to join the EU provides the underpinning for a strategy of harmonizing the legal and regulatory framework with that in the EU. Transparency practices regarding monetary and financial policies are generally in line with best practices, but weaknesses exist in the securities and insurance areas.

I. COMPLIANCE OF BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

A. General

61. An assessment of the institutional and legal framework for banking supervision according to the *Basel Core Principles for Effective Banking Supervision* was undertaken as part of the IMF–World Bank Financial Sector Assessment Program (FSAP), based on information up to September 2001. At that time, a new Banking Law had been drafted. The law has subsequently been passed, but the mission has not had an opportunity to review it.

62. The assessment of the observance of the Core Principles, following the *Core Principles Methodology*, was mainly based on the legal framework for banking supervision and the methods and procedures established by the supervisory authority. The Croatian National Bank (CNB) is responsible for the supervision of all banks and examines each of them around every second year. Some of the banks are examined more frequently depending on potential problems. The CNB's Banking Supervision Division (BSD) currently has around 70 positions (On-site Department: 45, Off-site Department: 18, and Department for

Supervision Improvement: 5).¹⁴ Assistance is also provided by the CNB's Legal and other divisions.

63. The assessment was conducted by Messrs. Roland Hopper (Oesterreichische Nationalbank) and Tonny Lybek (IMF). It was based primarily on information provided by BSD staff, both through interviews and in response to a questionnaire. In addition to the legislation, the assessment also benefited from interviews with representatives of a number of banks and external auditors. The authorities and other interested parties were very cooperative and participated fully in the discussions.

B. Institutional Market Structure

64. The legal framework of banking supervision in the Republic of Croatia is based on the *Law on the Croatian National Bank, the Banking Law*, and supporting regulations. Legislation delegates full responsibility for supervision of the banking system to the CNB and provides it with the necessary powers to regulate the banking sector. A draft Banking Law was circulated for comments among interested parties. The draft law intended to allow the harmonization with the pertinent European Banking Directives and covered nearly all the main areas deserving attention that are identified in this assessment. Legislation and regulations have been continuously adjusted to the developments in the banking sector, in part reflecting experiences with the banking crises in the mid-1990s and in 1998/99.

65. The supervisory authority is an integrated division of the CNB. It supervises 43 banks and 23 savings banks. Foreign majority owned banks accounted for around 88 percent of total assets as of September 2001. The number of banks has been significantly reduced. In the last five years, four banks and eight savings banks were closed and bankruptcy procedures were initiated for 13 banks and 5 savings banks. Banking activities are defined in the *Banking Law*. Domestic banks, foreign banks, and branches of foreign banks are treated equally.

C. General Preconditions for Effective Banking Supervision

66. Following the adverse developments in the banking sector in the late 1990s, the legal framework for banking supervision had to be adjusted to guarantee that appropriate legal action could be taken. The current *Banking Law* and supporting regulations allow the supervisor to ensure that banks comply with the law.

67. The *Banking Law* grants the CNB, which is the sole supervisory agency for the banking sector, authority to issue regulations and to set minimum standards for banking procedures and asset valuations. Regulations (*Decisions of the Council of the Central Bank*) are generally published in the *National Gazette* and are available on the CNB's web site. Breaches of legislation and regulations are penalized. The actions and sanctions that can be

¹⁴ A division consists of departments.

imposed against a bank are clearly described in the law. During the last two years, the CNB has revoked 12 licenses. Most of the larger banks are now owned by reputable and well-managed foreign banks. While the quality of the management, internal procedures, and risk management systems have generally improved, the recent Riječka Banka episode underscores the need for heightened attention to operational risk.

68. The activities a bank is allowed to conduct are defined in the *Banking Law* and depend on the minimum capital requirements (minimum license: HRK 20 million, medium license: HRK 40 million, and full license: HRK 60 million). The draft *Banking Law*, specified only one minimum capital requirement, which apparently was to be set at HRK 40 million. This may force some smaller banks, if they cannot raise their capital, to merge, transform into savings and loan cooperatives, or liquidate.

69. Banks in Croatia must use International Accounting Standards (IAS), and their annual financial statements shall be examined by external auditors on both a single and a consolidated basis. These audited financial statements are submitted to the CNB together with a special supervisory audit report, which obliges the external auditor to comment on special issues (internal controls, internal audit, risk management systems, etc.). The external auditor is also required to report any violations immediately to the CNB.

70. Branches of foreign banks are subject to the same procedures set for the domestic banks and are also subject to on-site examinations. Agreements to exchange information with foreign supervisors have not yet been established. The legal provisions to authorize the CNB to establish international agreements are included in the draft *Banking Law*.

D. Main Findings

71. Most of the Core Principles for Effective Supervision are either observed (13) or broadly observed (8).¹⁵ Weaknesses were found regarding consolidated supervision, which has influenced the assessment of other principles (7). Thus, only two principles are not observed, of which currently one is of limited importance and the second refers to international cooperation.

72. The BSD representatives are fully aware of the remaining weaknesses in the existing legal framework and procedures. The draft of the new *Banking Law* addressed these deficiencies.

73. The CNB is allowed to grant and revoke banking licenses. It is granted sufficient authority and independence to ensure a stable, sound, and safe banking system. Its broad guiding objectives are indirectly set out in the Law on the CNB and the *Banking Law* but could be more clearly defined. Supervisory staff should be given explicit legal immunity for actions taken in good faith during the discharge of their duties. The restructuring of the

¹⁵ Principle 1 really consists of 6 principles, accordingly 30 principles are assessed.

Supervision Division in order to prepare for the new tasks and the necessary specialization will require staff resources. Therefore, some on-site examinations may be delegated to external auditors.

74. The supervision of banks is carried out by the BSD through on-site and off-site examinations. Although the supervision is quite efficient, the analyses are conducted on single entities only and not on a consolidated basis. The development of appropriate procedures to calculate and set limits for market and other related risks is in process. The existing legal framework does not allow the CNB to formally establish international agreements, which would be very important due to the significant presence of foreign banks.

The Basel Core Principles can be grouped in the following categories:

Legal framework (CP 1)

75. The existing legal framework grants authority to the CNB to carry out banking supervision and issue supporting regulations to ensure sound banking practices. If a bank fails to comply with the law, the CNB has extensive power to take appropriate action. However, in order to meet European standards, and to address some weaknesses, a new *Banking Law* had been drafted, which provided for legal immunity to the supervisory staff for actions taken in good faith while discharging their duties.

76. The proposed law would enable the CNB to establish regular contact with other supervisory authorities, which so far has been done only on an informal basis.

77. The BSD is financed under the CNB's budget. A reorganization of the Division is considered and envisages delegation of some on-site examinations to external auditors.

Licensing and structure (CP 2–5)

78. Domestic and foreign banks are subject to the same licensing requirements and procedures. A detailed manual for the licensing process is not in use, but in practice, the procedures and requirements are comparable with European practices. Before granting a license to a foreign bank, the CNB requests the opinion of the home country supervisor. The CNB grants three types of licenses, depending on different capital requirements and the experience of the management. The activities banks can perform are explicitly listed in the law.

79. For the acquisition of stocks that exceeds ten percent of the share capital of a bank, prior approval of the CNB is required. The CNB receives reports about the shareholders of a bank quarterly. However, a follow up evaluation about the indirect shareholders—after the license had been granted—has so far not been done.

80. The investments in land, buildings, equipment, business premises shall not exceed 30 percent of risk-based capital, and including equity participation in companies, shall not exceed 70 percent.

Prudential regulations and requirements (CP 6–15)

81. The regulatory framework largely complies with international standards. The minimum capital ratio is above the Basel recommendation and is set at 10 percent and applies to all banks. However, the calculation of this ratio is based on credit risk only, and capital requirements for market risks and related risks still have to be developed.

82. The CNB has issued minimum standards for the banks concerning the assessment of asset quality and strict instructions about the provisioning broadly consistent with international practice. The limits on large exposures and connected lending are consistent with international benchmarks. However, supervision on a consolidated basis is proposed in the new law and has not been done yet, which restricts the ability to ensure compliance with the above-mentioned limits on a consolidated basis.

Methods on ongoing supervision (CPs 16–20, 22)

83. The BSD is divided into three departments. The Off-site Department analyses the reported data on a quarterly basis, whereas consolidated oversight is only done once a year based on externally audited financial statements. The reorganization of the Division will reinforce the Off-site Department through internal restructuring, in order to be prepared for the new tasks envisaged in the draft *Banking Law* (consolidated supervision, and guidelines for the calculation of market and other risks).

84. The CNB's reporting requirements are numerous, which enables it to identify critical developments. A simple early-warning system developed by the CNB's Research Department, looking at liquidity indicators and deposit rates offered by banks, is used and is expected to be further developed. Data submitted to the CNB is verified through quite extensive on-site examinations and external auditors who have to submit, in addition to the approved financial statement, a special audit report according to CNB regulations. In the near future, external auditors will execute some onsite examinations. CNB officials state that following the recent banking crisis, contacts between supervisors and the banks are often intense.

85. The CNB can impose a graduated range of sanctions in the event that a bank does not comply with the supervisory requirements.

Information requirements (CP 21)

86. Croatian banks must use International Accounting Standards (IAS). The same auditing company may not perform more than four successive audits of financial statements of the same bank. The financial statement of the bank with the auditor's opinion has to be published once a year, both on a single entity as well as on a consolidated basis.

Cross-border banking (CPs 23–25)

87. The current legal framework precludes the establishment of formal agreements with foreign supervisory agencies, but this will be alleviated as envisaged in the draft *Banking Law*. However, a prior opinion of the home country supervisory authority has to be received as part of the procedure when a foreign bank wants to open a subsidiary or a branch. The branches of foreign banks are subject to the same reporting requirements and on-site examinations as other banks.

Table I.1. Main Findings of Assessment of Implementation of the Basel Core Principles for Effective Banking Supervision

CPs Main Categories	Main Findings
Objectives, Autonomy, Powers, and Resources (CP 1)	The independence of the supervisory authority for banks is granted through the Law on the Croatian National Bank. The institutional framework and tasks are set out in the <i>Law on the Croatian National Bank, Banking Law, Decision on Conducting Banking Supervision of Bank Operations</i> (National Gazette n.50/2000), and other supporting regulations. The CNB has the necessary authority to perform its duties and to ensure that banks operate in compliance with the law. The supervisory division of the CNB is funded by the CNB budget. The number of staff will not be increased in the next few years, so some on-site examinations may be delegated to external auditors. At the moment, there is only some legal immunity for supervisory staff for actions taken in good faith, but this will be alleviated in the draft <i>Banking Law</i> . Agreements with other supervisory agencies have not yet been established, although information is occasionally exchanged on an informal basis.
Licensing and Structure (CPs 2–5)	The <i>Banking Law</i> protects the use of the term “bank” for institutions that are defined in this law and are granted an operating license. The CNB has the sole authority to grant and revoke banking licenses. The criteria, procedures, and documents to be submitted are clearly defined. However, after the licensing process, follow up on the indirect shareholders (or their sources of capital) is generally not done by the CNB. A bank’s permitted activities depend on its license and are explicitly described. The law on banks states that the acquisition of stocks, gradually or at once, which amounts to ten percent of the share capital of a bank and which provides such voting rights in the general assembly needs prior approval of the CNB. Investments in nonfinancial institutions are limited. A bank’s investment in land, buildings, equipment, and business premises must not exceed 30 percent of risk-based capital, and including equity participation in companies, 70 percent.
Prudential Regulations and Requirements (CPs 6–15)	Regulations concerning prudential requirements are in place. The guidelines issued regarding credit policies, loss-provisioning, assessment of bank exposure and loan classification are strict. But there are still some weaknesses connected with the deficiencies regarding consolidated supervision, which influence the monitoring of capital adequacy, large exposures, and connected lending. Regulations and supervision, especially in the field of market risks and related risks, have to be developed. Minimum capital requirements are in place, but the calculation of capital adequacy is based on credit risk only.
Methods of Ongoing Supervision	The <i>Banking Law</i> enables the CNB to perform off-site and on-site

(CPs16-20)	<p>supervision of banks. More than half of the staff in the Supervision Division is involved in on-site examinations. The Offsite Department analyzes all banks quarterly; a consolidated analysis is done only once a year. A simple early-warning system, based on liquidity and interest rate indicators is used. The supervision of market risks is still in the process of development. The staff in the Off-site Department will be increased through internal restructuring. Because of the reorganization of the departments, some on-site examinations will be delegated to external auditors in the near future. Supervision on a consolidated basis has not yet been implemented, but this is addressed in the draft <i>Banking Law</i>.</p> <p>The validation of the data submitted to the CNB is ensured through on-site examination as well as through the obligation for external auditors to report any material findings in their annual audit. According to CNB officials, the contact with the bank management is—due to the crises in the recent years and the extensive on-site inspection program—very intensive, while some banks and external auditors find it less intensive and suggest it be intensified.</p>
Information Requirements (CP 21)	<p>International Accounting Standards (IAS) are compulsory. The same auditing company may not perform more than four successive audits of financial statements in the same bank. The financial statement of a bank with the auditor's opinion has to be published once a year on individual and consolidated basis.</p>
Formal Powers of Supervisors (CP 22)	<p>The CNB is granted extensive powers to take legal action against banks that do not function in a sound and safe way or violate the law. The CNB can, e.g., revoke the license, request changes in the management and shareholders, forbid transactions, take other measures, and has also the authority to penalize violations. The new <i>Law on the CNB</i> has strengthened the CNB's autonomy to better address issues of the remaining state-owned banks. It is imperative for a sound banking system that this authority be used, including for remaining state-owned banks.</p>
Cross-border Banking (CPs 23-25)	<p>Formal relationships with foreign supervisory agencies have not yet been established but are part of the draft <i>Banking Law</i>. Identical rules for granting a license apply to domestic and foreign banks. A prior opinion of the home country supervision authority has to be requested as part of the procedure. Branches of foreign banks are subject to the same reporting requirements and are also subject to on-site examinations.</p>

E. Recommended Actions

88. Although banking supervision is quite efficient, the following issues need to be addressed:

- Except for annual published reports with consolidated accounts, supervision is conducted on single entities only and not on a consolidated basis.
- The minimum capital adequacy ratio is above the Basel recommendation and is set at 10 percent for all banks. However, the calculation of the capital adequacy ratio is based on credit risk only, and capital requirements for market and related risks still have to be developed.

- Supervisory staff should be given explicit immunity from legal prosecution for performing their duties in good faith.
- In the future, country risk will become more important and should also be given appropriate attention.
- Due to the lack of legal backup, agreements with foreign supervisory agencies have not yet been established, and in practice, coordination with other domestic supervisors appears to take place only on an ad hoc basis.

F. Authorities' Response

89. The authorities broadly agreed with the assessment, acknowledging that banking supervision is an ongoing exercise. The draft Banking Law seen by the mission generally addressed the identified weaknesses and allowed for more focus on risk-based supervision. The authorities acknowledge that it is imperative, with the envisaged structural changes in the banking sector, that any breach of prudential regulation be addressed promptly, bearing in mind the costs of previous experiences with forbearance.

II. OBSERVANCES OF CPSS CORE PRINCIPLES FOR SYSTEMATICALLY IMPORTANT PAYMENT SYSTEMS

A. General

90. An assessment of the observance of the *CPSS Core Principles for Systemically Important Payments Systems* was undertaken as part of the joint-Bank-Fund Financial Sector Assessment Program for Croatia. The assessment focused on two major payments systems—the Croatian Large Value System (HSVP) and National Clearing System (NKS)—both considered to be systemically important.

91. The assessment is based on information available up to the time of the main FSAP mission in September, and many of the changes and recommendations in the assessment have subsequently been implemented. The assessment was conducted by Messrs. Robert H. Keppler, (Senior Advisor, Financial Sector Development Department, World Bank) and W. E. Davies (formerly Reserve Bank of Australia). It was based mainly on information provided by the Croatian National Bank (CNB), including related laws, regulations, and other documents. The assessment benefited from discussions with CNB officials, representatives of the Financial Agency (FINA, formerly ZAP), the Central Depository Agency of Croatia (SDA), Croatian Bankers' Association, and several banks. The authorities and other interested parties were very cooperative and participated fully in the discussions.

B. Institutional and Macprudential Setting and Market Structure

92. The CNB, FINA, banks, savings banks, savings cooperatives, and Croatian Post provide payment services in Croatia. CNB oversees the payment system and has mandated responsibility for controlling and supervising all aspects of the national payments systems.

93. The predominant noncash payment instrument used by financial institutions and corporate entities is the payment order initiated by the payer requesting the transfer of funds from the payer's account to the account of the payee. Checks are used sparingly, mainly by individuals for low value payments up to a limit of HRK 1,000 and by corporations for cash withdrawal from FINA. Credit and debit cards are also used for noncash payments, including Automated Teller Machines (ATM) and Point of Sale (POS) networks.

94. Until recently, domestic payments in local currency were handled by FINA, which also has wider responsibilities for cash management, revenue compliance and the collection and compiling of public finance information. Payments in foreign currency may only be transacted through banks. Cross-border transactions can only be settled in foreign currency. Significant reform have been implemented involving the institutional framework, payments structure, and transmission. CNB's oversight of payment systems has been strengthened to ensure that all payment systems satisfy the evolving needs of all sectors of a modern market economy. The CNB recognizes that appropriate emphasis needs to be placed on risk mitigation, efficiency, and cost, and the reform strategy is designed to avoid the creation of liquidity, credit, and systemic risk.

95. The CNB, in conjunction with other relevant agencies, launched initially the real-time gross settlement system (HSVP) for large and time sensitive transactions and later a multilateral netting system (NKS) for small value payments. Also, as part of the reform process a new draft National Payments System Law was being reviewed at the time of the mission and was adopted in December 2001. A Unified Register of Business Entities' Accounts was being established within the CNB to keep records of accounts of all business entities in the country.

C. General Preconditions for Effective Payment Systems

96. There is a strong body of law supporting the national payment system and giving the CNB a clear and mandated responsibility for payment systems in general and systemically important systems in particular. Indeed, the legal framework has enabled the CNB to demonstrate strong leadership with regard to policy, organizational, operational and technical aspects of the two major systems mentioned above.

97. The HSVP is owned and operated by CNB and began operations on April 6, 1999 with participation confined to banks (including savings banks). It is a modern system using international best practices, procedures, and technology and has performed well. The low value NKS system, which began operations on February 5, 2001, has been developed by FINA to accommodate both credit and debit transfers. Operations are confined by law to credit transfers, so that the initial version of the NKS system operates on a gross basis in similar manner to that of the HSVP, with instructions processed on a prefunded basis up to an agreed limit. As of April 2002, commercial banks became responsible for maintaining and operating customer accounts held in the past with FINA, a major step in completing operational aspects of the high volume and low value system in the payments system reform process toward a market economy.

D. Main Findings

Strategic issues

98. The HSVP design is flexible and can readily be modified to support a fully collateralized intra-day liquidity facility, using eligible government securities whose ownership details are maintained in the SDA book-entry system. Computer supported functions should be developed and installed to provide a fully collateralized intra-day liquidity facility and real-time delivery-versus-payment (DVP) for secondary market trading in government and central bank securities. Linking HSVP and SDA will also facilitate an efficient form of DVP, but without the need for SDA to be a direct member of the HSVP system.

99. The low value NKS system was developed by FINA and its implementation ensures that the core payment systems in Croatia are fully compliant with best international practice for safety and soundness, provided that secondary back-up sites are developed.

Implementation of the payment system reforms has major implications for the institutional and operational role of FINA which is set out in the *Law of the Financial Agency*.

Observance of core principles

100. **The HSVP and the NKS systems are considered by the CNB to be of systemic importance and are broadly in compliance with the core principles.** A summary assessment for each system is set out below, which also includes an assessment of the CNB's role, in undertaking its payment systems oversight role. Some minor, nonmaterial deficiencies have been noted. These do not relate to systemic risk matters. The deficiencies are already recognized by the CNB and FINA and can be readily addressed in the next phase of the payment system reform process.

Table II.1. Main Findings of Assessment of Observance of CPSS Core Principles for Payment Systems—the Two Systemically Important Systems, the Croatian Large-Value System (HSVP) and the National Clearing System (NKS)

Subject	Main Findings
Well-founded legal basis in all relevant jurisdictions (CP 1)	The principle is broadly observed for both HSVP and NKS. There is a strong body of law supporting payments systems confirmed in discussions with CNB. The Domestic Payment Law is being replaced with new legislation which is comprehensive and soundly based. However, some aspects were not fully reviewed to judge consistency between Croatian and English versions. There are also strong supporting legal structures, including a bankruptcy law. Nevertheless, the legal position of exercising collateral and related issues was not totally clear. More broadly, legal certainty and any ambiguities such as 'zero hour' issues have not yet been tested in court. The interface between payments law and contractual law including issues such as enforceability could be examined further.
Understanding of the system's impact on risks; and procedures for the management of risks (CPs 2-3)	<p>For HSVP these principles are observed. Rules and regulations, operating procedures and manuals are comprehensive. Information is freely available from CNB, the owner, operator, and supervisor and details are also released on its web site. The main issues relate to the possible future introduction of an intraday credit facility, free of interest charges through fully collateralized overdrafts using repos and the possible impact that indirect membership of a wider range of institutions might have. Cross-border issues are not considered systemically relevant in the current stage of payments system development.</p> <p>For NKS these principles are observed. Rules and regulations, operating procedures and manuals are comprehensive. Information is readily available from FINA, the payments operator. Mandatory training sessions and seminars are held covering all aspects of the clearing system as a condition of membership. While NKS has been designed as a multilateral netting system, only credit transfers are</p>

	<p>processed on a gross basis today; the system is pre-funded with reserved deposits up to a limit for each participant agreed with CNB. Credit and liquidity risks do not arise.</p>
<p>Final settlement; inability to settle by the participant with the largest single settlement obligations (CPs 4-5)</p>	<p>For HSVP principle 4 is observed and principle 5 is not applicable. Payment transfers are processed continuously in real time and settlements are irrevocable.</p> <p>For NKS principle 4 is observed and principle 5 is not applicable as the system operates today. Payment transfers are processed gross during three provisional settlement cycles. Final legal settlement occurs at end of day over the HSVP in central bank funds, but the CNB guarantees the settlement from its provisional settlement until its legal finality at the end of the day, since the transactions are prefunded. Future broadening of the system's operations to cover debit transfers as is typical of a traditional multilateral netting system will require a detailed assessment of risk management and related issues.</p>
<p>Assets for settlement (CP 6)</p>	<p>The principle is observed for both HSVP and NKS.</p>
<p>Security and operational reliability; and contingency arrangements (CP 7)</p>	<p>For HSVP the principle is partly observed. The system is robust from both technical and operational aspects. It uses modern technology and makes maximum use of existing S.W.I.F.T. facilities. However, back-up facilities are not located at a remote secondary site and thus do not protect the system from the impacts of a disaster at the primary site.</p> <p>For NKS this principle is partly observed. The system is robust from a technical architectural perspective. Modern fault tolerant, authentication, and encryption capabilities are used. Contingency plans and back-up facilities are in place and have been tested. However, the back-up capability is based on cold back-up site philosophy and should be improved to enhance user confidence and guarantee more efficient business continuity arrangements. FINA is largely responsible for the design and functioning of the system because of the historical past. User requirements reflecting the new customer accounting regiment requirements, as perceived by FINA, have been incorporated in the design. Care has also been taken to reflect the needs of large banks for electronic input of data, as well as small banks who will have the opportunity to submit their transactions in paper format for conversion by FINA local offices in electronic form.</p>
<p>Practical for the markets and efficient for the economy (CP 8)</p>	<p>For HSVP the principle is broadly observed. Payments reform has brought many improvements and benefits as compared with earlier days in regard to risk mitigation, transaction cost reduction and processing efficiency (intraday finality). Risk reduction policies, though important, are only one element among several that needs to be balanced in a continuation of the reform process. User needs for a better use of the available liquidity and implementation of a suitable DVP capability for securities transactions would increase the utility of the system and enhance its usefulness and acceptance.</p>

	<p>For NKS the principle is broadly observed. Clearly payments arrangements are more efficient than in the recent past. Transaction pricing has been improved. However, other relevant issues including the role of liquidity management in a more market-oriented environment, and the way in which debit transfers will be processed will require substantial discussion to assure an acceptable trade-off between risk mitigation and the efficiency requirements of users. It is, however, an ongoing effort to assure the efficiency of the payment systems.</p>
Objective and publicly disclosed criteria for participation (CP 9)	The principle is observed by both systems.
Governance of the system should be effective, transparent and accountable (CP 10)	<p>For HSVP this principle is broadly observed. The system has an effective government structure, transparent with adequate disclosure of regulations and procedures. There is scope to report more regularly on operations and decision-making processes to participants and the public. The publication of the proposed document (similar to the BIS Red Book) will be a further step in broadening understanding of payment system issues.</p> <p>For NKS this principle is partly observed. The NKS does not have a clear board of management structure with representatives of the relevant stakeholders separate from FINA.</p>
Responsibility A. Publicly disclosed policy relating to the role of the central bank in regard to all systemically important payment systems.	Observed.
Responsibility B. Ensure that the core principles are applied to systems owned by the central bank	Observed.
Responsibility C. Ensure that the core principles are applied to other systemically important payment systems.	Broadly observed. CNB has developed an organizational structure whose responsibilities include payment system oversight. However, the present organization structure does not clearly separate oversight responsibilities from operational responsibilities. Up to now this responsibility has not been exercised in regard to systems not owned and operated by the central bank. Oversight of the competitive environment and other public interest issues is also important. Such broader responsibilities should be included in the next stage of the payment system reform process.
Responsibility D. Cooperation with other central banks.	Partly observed. CNB needs to establish appropriate formal and informal channels with other agencies and supervisory bodies as vehicles for discussion and cooperation in payment system issues and related policies. A more formal framework for information sharing and coordination, e.g., Memorandum of Understanding, should also be considered where appropriate so that there is a broad network to promote safety and efficiency issues. It is also important to ensure that decisions by various agencies do not cut across objectives of others in clearance and settlement matters, especially those relating to cross-border payments.

E. Authorities' Response

101. At the time of the mission, the authorities broadly agreed with the assessment, noting that they then drafted *Payment System Law*, and the draft *Law on Financial Agency* will provide the necessary legal framework to achieve the objectives identified by the assessment. Measures to address deficiencies regarding back-up facilities were being considered.

III. OBSERVANCE OF IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION

A. General

102. As part of the joint Bank-Fund Financial Sector Assessment Program for Croatia, an assessment was made of observance of the IOSCO Objectives and Principles of Securities Regulation. This assessment was conducted by Messrs Yongbeom Kim (Senior Financial Economist) and Noritaka Akamatsu, (Lead Financial Economist) (both, World Bank). The assessment is based on information available until the main FSAP mission in September 2001. At that time a new draft *Securities Law* was being considered. Subsequently, the law was passed, but the mission has not had an opportunity to review it.

B. Institutional Market Structure

103. While the Zagreb Stock Exchange (ZSE) was established in 1991, and the Croatian Securities Commission (CROSEC) in 1996, securities markets remain underdeveloped and have limited significance for the overall financial system. Activity is also limited on the Varazdin Stock Market (VSM)—the over the counter market.

104. In terms of their self-regulatory functions, both exchanges occasionally exercise inspection authority and also assume important, albeit limited, roles in market surveillance. Neither exchange is actively involved with investor education programs. Banks play an important role in the securities business as active underwriters of securities, while independent securities companies focus on niche markets. The draft *Securities Law* envisages banks engaging in the securities business through a separate subsidiary or in-house operations, further intensifying the role of banks in the securities industry. The more banks become involved in the securities market, the greater the need for requiring proper internal control systems within the banks. This requires close cooperation between the CROSEC and the CNB in regulating and supervising financial institutions.

105. The current systems for clearing and settlement of securities are efficient, safe, and effective. The plans to reduce the settlement period to T+3 aside, the Central Depository Agency of Croatia (SDA), and the CNB are working together to transfer the depository of CNB bills to the SDA. The ownership structure of the SDA, which is currently owned by the government, is an important policy issue to be addressed. Majority ownership should be in the hands of market participants.

C. General Preconditions for Effective Securities Supervision

106. At present the CROSEC has limited authority over inspection, investigation, and surveillance. These functions plus enforcement are not articulated in the *Securities Law*. Further, no provisions or observed procedures exist that define what the regulator may or may not do when exercising such authority. As a result, the regulators often face strong resistance from securities companies and issuers alike when attempting to conduct

inspections and investigations. Moreover, the CROSEC seems ineffectual in imposing sanctions against any violations.

107. While the basic legal and regulatory framework was established starting in 1995, the laws and regulations require significant updating. They lack clarity and do not provide sufficient authority to the regulator. The draft *Securities Law* would be a major step towards strengthening the legal framework, although there remains considerable room for further improvement. In addition, three other laws need to be reviewed and strengthened: the *Law on Investment Funds*; the *Law on Privatization Investment Funds*; and the *Law on Takeover*.

108. Legislation has been drafted to address several key weaknesses in corporate governance. Draft changes to the existing legislation would amend: (i) provisions in the *Company Law* 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; and (ii) provisions on inadequate disclosure of ownership and control structures in the *Securities Law*.

D. Main Findings

109. The assessment indicates that there is considerable room for improvement in the observance of the IOSCO Core Principles. Out of the 30 core principles, four are “implemented,” 25 “partially implemented,” and one “not implemented.” However, “partially implemented” principles involve a wide spectrum in terms of the degree of implementation. The core findings point to the need for strengthening the powers of CROSEC, clarifying its procedures for inspection and surveillance, and improving coordination between CROSEC and CNB.

110. With respect to the principles relating to collective investment schemes, the assessment finds: lack of clarity in the relationship between the investment company and the owners of share certificates of an open-end fund; lack of arms-length relationship between an investment company and a depository bank; ambiguity in the methodology for calculation of net asset value of the fund; and need for strengthening the ban on transactions with related parties.

111. With respect to the principles for market intermediaries, the shortcomings in proper prudential regulation are compounded by the lack of staff to perform on-site inspections of intermediaries. With respect to the principles for issuers, the definition of securities is vague and broad, while the issuance of commercial papers appears to be over-regulated.

E. Recommended Actions

112. The *Securities Law* should define clearly the objectives of securities regulation and the CROSEC should have adequate resources to properly execute its mandate. Enforcement authority of the CROSEC needs to be clarified and strengthened, specifically the power to revoke licenses. The draft *Securities Law* should grant the CROSEC adequate legal authority

to impose corrective measures on securities firms. Information sharing mechanisms with other domestic and foreign regulators also need to be enhanced, including correcting the ambiguity surrounding bank secrecy requirements.

113. Disclosure requirements for issuers should extend to: (i) supplementary documents prepared in an offering; (ii) information about those holding a material stake in a listed company; and (iii) timely reports. Major shareholding information of companies, especially those of listed companies, should be disclosed within a shorter period of time. Commercial papers could be excluded from the definition of securities.

114. The *Law on Investment Funds* should make certain that separate assets of an open-end fund would not be subject to claims against the investment company in the case of bankruptcy. It also needs to define an arms-length relationship between an investment company and a depository bank. A clearer definition of related parties should be incorporated in the law.

115. The risks associated with the involvement of banks in securities business through their in-house departments should be carefully assessed. The regulator needs to ensure that a proper internal control system is in place within a market intermediary. The majority ownership of the SDA should be transferred to private hands.

116. With respect to the government securities market, it is recommended that a committee be established encompassing all key market participants, both public and private sectors, to address interdependent complex tasks. In the primary markets, tasks include: enhancement of the issue practices in terms of issuance frequency, announcements, and introduction of new instruments. In the secondary market: (i) proper organization of secondary government securities trading systems, including trading on ZSE; and (ii) clarification of regulatory responsibilities for the market among the CROSEC, MoF and CNB.

F. Authorities' Response

117. The CROSEC generally agrees with the assessment. Moreover, it plans to address most of the recommendations made related to improving compliance with the IOSCO Principles. The CROSEC's response to the assessment is as follows:

- Ambiguities surrounding certain concepts-public offering, public companies-under the *Securities Law* are partly due to the manner in which privatization occurred in Croatia.
- The CROSEC's independence is a function of political willingness to grant it more funds and to stop interfering in its day-to-day business. Staff fluctuation remains at a very critical level.
- The distinctions among the words "inspection," "investigation," and "surveillance" are somewhat blurred in the Croatian language.

- The CROSEC is also aware that disclosure requirements are insufficient, leaving much improvement to be desired. Auditing is another area that remains below par.
- Investment fund is a new concept to the country. To date, the CROSEC could not set stricter standards concerning fund managers because it lacks qualified people with adequate experience.
- If the CROSEC attempted to strictly regulate capital adequacy of securities firms, then the large majority of the brokerage houses would become insolvent. Customers' money is kept in a segregated account, but due to a staff shortage, the CROSEC is not able to inspect them properly.
- Arguing a case of market manipulation is very difficult when any order that is a little larger than the norm sways the market upward or downward by some 20 percent or 30 percent.

IV. OBSERVANCE OF IAIS INSURANCE SUPERVISORY PRINCIPLES

A. General

118. This assessment was performed as part of the FSAP assessment for the Republic of Croatia by Donald A. McIsaac, Lead Insurance Specialist (World Bank). The assessment is based on information available at the time of the main FSAP mission in September 2001.

B. Institutional Setting and Market Structure

119. The insurance legislation imposes minimum capital requirements but also specifies a solvency margin once companies reach a certain size. Legislation and supporting regulations generally resemble those of the EU, although some differences remain. Minimum capital requirements for insurance companies are substantial when compared to those prevailing in other transition or developing economies. It would require HRK 16 million (approximately US\$ 2 million) to start a life insurance company and HRK 33 million to start a composite insurance company. The Insurance Companies Supervisory Authority (ICSA) reports that only two companies, with small market shares, have failed to meet the requirements as of the end of June 2001.

120. The primary focus of insurance supervisory efforts is the monitoring of solvency and capital adequacy. ICSA had become concerned over the adequacy of liability estimates that insurance companies were posting in respect of their obligations to policyholders. In 1998 it sponsored issuance of new regulations that prescribed the minimum expectations for establishment of technical provisions. The calculations are now to be supported by the report and opinion of a qualified actuary. The consequence of this initiative has been a strengthening of insurance liabilities, although this has had a negative impact on the operating results of some companies over the two recent business years.

121. ICSA has less than 10 professional employees on its staff. Its budget is constrained by the obligation to collect 90 percent of its revenues from the industry, subject to a maximum annual assessment. The consequence is an inability to develop a compensation program that is adequate to attract and retain sufficient numbers of competent professional staff. Thus, consequence of these realities, the supervisory authority confines its activities mainly to the review of information filed by the licensed companies and few on-site inspections are conducted.

C. General Preconditions for Effective Insurance Supervision

122. It is estimated that less than 3 percent of the population is covered by life insurance and less than 1 percent by private health insurance. The market, thus, has considerable scope for development. The practice has developed of issuing life insurance contracts whose values are based on a "hard" currency, but with consumers paying premiums with the equivalent amount in local currency, or "kuna." While this presents the consumer and the insurer with a

potential currency risk, it may be the only way to win back public confidence in insurance as a savings vehicle.

123. Insurance companies are incorporated according to the *Commercial Code* which is expected to be amended. The envisaged changes will have an effect on the corporate governance of general-purpose corporations, but the provisions do not go far enough in protecting the interests of policyholders. For this reason, laws such as the *Insurance Act* should include special provisions outlining the responsibilities of Directors and identifying the roles they must play.

124. Accounting for insurance companies is governed by the general *Law on Accounting*. Special regulations have been issued, pursuant to the *Insurance Act* and the *Law on Accounting*, prescribing accounting and financial reporting requirements for insurance companies. The rules have the effect of ensuring that Croatian insurance companies prepare their accounts in accordance with the rules established by the EU Insurance Directives for its member countries. Financial returns are to be accompanied by reports and opinions issued by an auditor and an actuary.

125. An important new feature of the regulations is the requirement for derivative reports. When the actuary becomes aware during the course of a regular review that a situation is developing that could impair the ability of the company to meet its obligations, the actuary is obliged to make the situation known to the authorities.

126. In order to be authorized to issue an opinion, actuaries must be members of the local actuarial society and licensed by the Ministry of Finance. As a result of a program of training developed with the support of the UK Government Actuary's Department, a cadre of 30 newly trained and qualified actuaries is now present in Croatia.

127. There is at present no insurance trade association in Croatia, although there is an insurance committee within the Chamber of Commerce. The Croatian Insurance Bureau manages the special fund that is maintained by the motor insurance companies to support compensation payments to persons who suffer bodily injury or property damage as a result of motor vehicle accidents involving uninsured motorists. This fund would also serve as a backstop to cover such liability claims in the event of the insolvency of a member insurance company.

128. The court system in Croatia is slow in settling claims against insurance companies. These delays have caused problems for companies and their claimants, and have also led to a lack of consumer confidence in the insurance industry.

D. Main Findings

129. The review of the compliance with the Core Principles for Effective Supervision established by the IAIS concludes that Croatia is "observant" or "broadly observant" of 9 of the 17 Core Principles. Three principles are "partly observed," one is judged "not applicable," and 4 are rated as "not observed." The system is judged to be "not observant" of

the principles dealing with corporate governance; internal controls; on-site inspection; and reinsurance. Since the resources of the authority are so limited, it is judged to be only “partly observant” of the principle on organization of a supervisory authority.

Table III.1. Main Findings of Assessment of Observance of the IAIS Insurance Supervisory Principles

Subject	Main Findings
Organization of an Insurance Supervisor (CP 1)	Supervisor has authority to issue licenses and general operational independence. No procedures manuals have been prepared. Resources are limited as a result of formula that ties revenues to premium income. Compensation is based on public service scales. Organization has few professionals and no actuary. Members of staff do not have legal immunity. Staff are subject to confidentiality rules set by a Regulation of Professional Secrecy. Head of the authority is appointed for a fixed term but can be removed at any time. Grounds for removal are not specified
Licensing and Changes in Control (CPs 2-3)	Foreign investors can acquire domestic companies, establish subsidiaries, or launch a “branch” operation. Suitability of owners, the CEO and the Board of management are assessed through a process that involves application of a special MoF questionnaire and scrutiny of the source of funds exercised by ZAP. No person, natural or juridical, may hold more than 15 percent of the shares of an insurance company without the approval of the supervisor.
Corporate Governance and Internal Controls (CPs 4-5)	Limited provisions for corporate governance appear in the <i>Commercial Law</i> and these would apply to insurance companies as they would to other types of corporations. However the insurance laws of Croatia fail to specify the unique responsibilities that must be borne by the members of the Supervisory Board of an insurance company. There are no requirements specified in the insurance legislation with respect to internal control and the supervisor does not receive reports concerning the application of internal control systems.
Prudential Rules (CPs 6-10)	Insurance legislation contains provisions governing the nature of investments that insurance companies may use to support their liabilities and required capital. The supporting regulations specify the liabilities that an insurance company must establish in support of its

	<p>obligations to policyholders and provide rules for computing these liabilities. The legislation specifies both minimum capital requirements to be met from the date of licensing and a solvency test formula that resembles that which prevails in the European Union. The insurance supervisor has not set any requirements regarding reinsurance and does not collect information on the treaties that are arranged by local companies.</p>
<p>Market Conduct (CPs 11)</p>	<p>The supervisory authority does not require company Boards to establish written policies for fair treatment of policyholders. However, Croatia has recently adopted a new Law applicable to Insurance Agents and Brokers whereby insurance intermediaries are obliged to establish good conduct and ethics rules for the behavior of sales representatives. The supervisory authority does not have a role as an ombudsman nor can it resolve disputes</p>
<p>Monitoring, Inspection and Sanctions (CPs 12-14)</p>	<p>The <i>Insurance Act</i> and regulations prescribe rules for the presentation of financial statements of insurance companies and this parallels the model specified for insurance companies in the Directives of the European Union. By virtue of section 65 of the legislation, the supervisor is empowered to carry out checks on the operations of the insurance companies at any time although some companies advise that they have not experienced an inspection visit for many years. The supervisor has considerable powers in intervention when dealing with problem companies.</p>
<p>Cross-Border Business Operations, Supervisory Coordination and Confidentiality (CPs 15-17)</p>	<p>There are at present no “branch” operations in the country and Croatian companies do not carry on business in other territories. There do not appear to be any agreements or MOUs that would permit the staff of the supervisory authority to share information with supervisors in other jurisdictions nor with supervisors of other types of financial institutions. All information collected in connection with the activities of supervision is to be kept confidential</p>

E. Recommended Actions

130. In the short term, there should be a review of the organization and the resources available to enable the supervisory authority to effectively discharge its functions. At present, the authority cannot offer adequate compensation that will permit it to recruit and retain sufficient numbers of competent staff. For example, because the authority has no actuary, it cannot review the reports and the findings submitted by company actuaries.

131. A program of technical assistance could be provided that would design an organization chart indicating essential skills the authority must possess. Supervisory procedures could also be developed with the support of this technical assistance to ensure that all aspects of supervision are properly covered.

132. In the medium term, there should be a review of the regulatory and supervisory system to ensure complete conformity with EU practices.

F. Response from Supervisor

133. The Director of the Insurance Companies Supervisory Authority has provided comments on the findings of this assessment. Plans are underway for another revision to Croatia's insurance legislation. Many of the observations made in this assessment will be remedied by the amendments that will be proposed. The Director expressed appreciation for the effort and suggestions offered for improvement of the regulation of insurance markets in Croatia.

134. The Director offered the following specific observations:

- The Insurance Companies Supervisory Authority has not released procedures manuals concerning licensing procedures because it is of the view that all conditions that must be met by the founders of insurance companies are stated in the legislation.
- It is the opinion of the Director that the matter of legal immunity for members of the staff of ICOSA is resolved by Article 72 of the *Obligation Act*. This act applies to employees of both private and public companies evidently. According to its provisions, liability for damages caused to a third party by the actions of an organization rests with the organization and not with the employees who were involved in the action.
- With reference to observations in the assessment that have to do with obligations on management of a corporation in such areas as corporate governance, the Director expressed the view that such matters are dealt with in the *Commercial Law*. Roles of management are to be prescribed in the Charter of the company on the basis of the *Commercial Law* and the charter must be reviewed and accepted by ICOSA. This applies to the review when a company is first licensed as well as to any proposal to amend the charter. The Director believes that other matters relating to corporate governance can also be regulated through the process of review of the company

Charters. Issues of this nature that relate to both management of companies and the Supervisory Board will be clarified and elaborated in the forthcoming round of revisions to the insurance legislation.

- With respect to the control over reinsurance, insurance companies are expected to supply information concerning their retention practices at the time of licensing. Subsequent monitoring is based on a review of financial statements that are submitted periodically. While this might be somewhat indicative, it will be a less effective review than could be achieved by a regular, perhaps annual, review of reinsurance treaties.
- ICSA has published a general Code of Behavior of Insurance Companies. This code has been accepted by all insurance companies, through the intervention of their trade association. By virtue of this code, the companies have agreed to apply standards of fair treatment of their policyholders, such as would be expected by virtue of Core Principle 11.

V. OBSERVANCE OF IMF'S CODE OF GOOD PRACTICES ON TRANSPARENCY IN THE MONETARY AND FINANCIAL POLICIES

135. The following is a summary of the assessment of the transparency practices of monetary and financial policy in the Republic of Croatia based on the IMF's *Code of Good Practices on Transparency in Monetary and Financial Policies*. The assessment was undertaken as part of the joint IMF–World Bank Financial Sector Assessment Program (FSAP) by Mr. Marco Arnone (IMF) in collaboration with the relevant experts and based on information up to September 2001 when the main FSAP mission took place.

A. Monetary Policy

Legal framework, institutions, and market structure

136. The legal framework for conducting monetary policy is laid out in the *Law on the Croatian National Bank* and supporting regulations. The CNB pursues the objective of price stability under a managed float exchange rate regime without any preannounced path for the exchange rate. Monetary policy operations, including exchange market intervention, are geared to keep the exchange rate stable against the euro and smooth its seasonal pattern without resisting large or persistent exchange market pressures. Monetary policy instruments include repo auctions, domestic and foreign currency-denominated CNB bills, foreign exchange intervention, the Lombard facility for purposes of short-term liquidity adjustments, a Short-term Liquidity Loan facility for assisting structurally illiquid but solvent banks, and reserve requirements.

Main findings

137. The CNB observes the majority of good transparency practices regarding monetary policy. The findings regarding the clarity of responsibilities and objectives, the process of formulation and reporting of policies, availability of information on monetary policy, and accountability and integrity of relevant agencies are discussed below.

Clarity of roles, responsibilities, and objectives

138. The ultimate objectives of monetary policy are defined in Article 3 of the *Law on the Croatian National Bank* as: to “achieve and maintain price stability,” and only as a secondary objective “support the economic policy of the Republic of Croatia,” if this does not conflict with the primary objective.

139. In monitoring price developments, careful attention is paid to exchange rate stability. The CNB uses monetary policy operations (including occasional exchange market intervention) to keep the exchange rate stable against the euro and smooth its seasonal pattern, without resisting large or persistent exchange market pressures. This creates some ambiguity regarding the intermediate target and the ultimate objective.

140. The governing body of the CNB is the Council of the Croatian National Bank. It consists of the Governor, the Deputy Governor, and Vice Governors by virtue of their office, and by eight external members at the most. All members are appointed, with different procedures, by the Croatian Parliament for a term of six years. The CNB is an independent institution accountable to the Parliament of the Republic of Croatia. The CNB submits to Parliament its Annual Report, which includes a description of monetary policy, banking supervision and payment system activity. The CNB stands ready to provide Parliament any additional information it might require.

Open process of formulating and reporting of policies

141. Most good transparency practices for formulating and reporting monetary policy are broadly observed. The CNB informs the public immediately after decisions have been taken about changes in the setting of monetary policy instruments, although it could be more explicit regarding the underlying rationale of policy decisions in order to provide greater clarity. This could be accomplished by issuing explanatory press releases in conjunction with key policy decisions.

142. Operating procedures are outlined in circulars that are sent to all financial institutions and the media and issued periodically as a book. Public consultation is sought for most important technical adjustments. Some macroeconomic developments are described in the *Monthly Bulletin*, in the *Quarterly Report* and the *Annual Report*. These reports briefly analyze the developments, but do not provide a forward-looking outlook. Information on inflation developments and outlook could be provided more regularly. The CNB has no single publication that clearly outlines and explains its monetary policy framework and how it uses its various instruments.

Public availability of information on monetary policies

143. Most good transparency practices related to the public availability of information on monetary policy are observed. General macroeconomic developments are described in the CNB's *Annual Report* (issued typically at end-March), in the *Quarterly Report* and in the *Monthly Bulletin*. These publications contain descriptions of the most important developments in the real sector, employment and wages, monetary aggregates, balance of payments, exchange rate, and public finance. The *Annual Report* also contains more detailed comments on GDP growth, employment, and inflation. However, implications of the assessment of the current situation for the monetary policy objectives are not regularly or consistently provided. The press releases following the CNB Council meeting provide some information. These publications are either posted on the website or available upon request.

144. Croatia is a subscriber of the IMF's Special Data Dissemination Standard (SDDS). Although deficiencies in statistics remain a concern, reporting and disclosure of monetary and banking statistics are more regular and extensive. While there might be room for further improvement in reporting of data on the banking sector, those on the monetary instruments are posted on the website and are regularly updated.

Accountability and assurances of integrity by financial agencies

145. The Governor of the CNB appears on request before the Croatian Parliament, while senior CNB officials occasionally participate in seminars or discussions. The financial statement and the overall operations of the CNB must be audited by an independent external auditor in accordance with audit regulations and the International Standards of Auditing. The CNB must, submit to the Croatian Parliament a statement on its financial conditions, no later than five months after the end of the financial year. A summary of the audited balance sheet is published in the Annual Report. The CNB has stated that it will submit to Parliament the information on accounting policies and any qualification of the statement, including the auditors' report.

146. Standards for the conduct of personal financial affairs of the members of the Board of Directors and of the staff of the CNB are set out in the new *Law on the Croatian National Bank* which came into effect in 2001. The CNB also has an Ethical Code that is not published and internal governance procedures of the CNB are not publicly disclosed. There are no formal legal protections for CNB staff, although provisions were being made at the time of the FSAP mission in September in the draft of the new *Banking Law*.

Table IV.1. Main Findings of Assessment of Observance of MFP Transparency Code—Monetary Policy

Subject	Main Findings
I. Clarity of rôles, responsibilities and objectives of central banks for monetary policy	<p>Most practices are observed or broadly observed.</p> <p>In monitoring price developments, careful attention is paid to exchange rate stability. This might cause, at times, ambiguity between the intermediate target and the ultimate objective.</p>
II. Open process for formulating and reporting monetary policy decisions	<p>Most practices are observed or broadly observed.</p> <p>There is no publication that explains the monetary policy framework. The CNB informs the public immediately after decisions have been taken about changes in the setting of monetary policy instruments, but the explanation and clarity of policy changes can be enhanced.</p> <p>The schedule of Board meetings is not published.</p>
III. Public availability of information on monetary policy	<p>Most practices are observed.</p> <p>Implications of the assessment of the current situation for the monetary policy objectives are not regularly or consistently provided.</p>
IV. Accountability and assurance of integrity by the central bank	<p>Most practices are observed.</p> <p>Internal audit procedures are not publicly disclosed.</p>

Recommended actions

147. Measures to further improve observance of the Transparency Code include; (i) regularly publishing information on the CNB's views with regard to the macroeconomic outlook, with special attention to inflation, exchange rate, interest rates, balance of payments and liquidity; (ii) issuing a publication that explains the CNB's monetary policy framework, its objectives and operating targets and how it uses its instruments; (iii) issuing explanatory press releases in conjunction with monetary policy decisions; (iv) posting the schedule of Board meetings on its website; (v) disclosing internal operating procedures of the Internal Audit; and (vi) publishing the CNB's ethical code.

Authorities' response

148. The CNB was in agreement with the mission's assessment and stressed that it would address most of the issues raised. The CNB deserves credit for the broad-ranging and high quality information it provides on its website. The *Annual Report* and the monthly *Statistical Bulletin* are posted on the website and the latter is available in excel format. Also, relevant legislation, press releases, the major circulars and information on some monetary policy operations are available on the website. The mission encourages the CNB to continuously expand the information disseminated through this channel. In particular, the CNB could make available through the internet a descriptive and explanatory note on its monetary policy framework and the schedule of meetings of the Board.

B. Transparency of Banking Supervision

Institutional and market structure

149. The Croatian National Bank (CNB) is the sole agency responsible for banking supervision and regulation. Its broad objectives and the institutional framework are set out in the *Law on the Croatian National Bank*, the *Banking Law* and supporting regulations. At the time this assessment was undertaken (September 2001), the new *Banking Law* was being drafted and circulated for comments to concerned parties. Information on the structure of the banking system is provided in Section I of this Financial System Stability Assessment report and on the CNB's website.

Main findings

150. The CNB observes most of the good transparency practices in the area of banking supervision. The findings regarding the clarity of responsibilities and objectives, the process of formulation and reporting of policies, availability of information, and accountability and integrity of relevant agencies are discussed below.

Clarity of roles, responsibilities, and objectives

151. The CNB's supervisory responsibilities and objectives are set out in the *Law on the Croatian National Bank* (henceforth Central Bank Law), in the *Banking Law*, in the *Decision on Conducting Banking Supervision of Bank Operations* and supporting regulations. An objective is specified in the *Banking Law*, Art. 67: "the CNB shall assess a bank's ability to manage business risks and introduce measures for eliminating illegalities and irregularities." Moreover, article 4 of the Central Bank Law states that "issuing and revoking licenses for banks, bank supervision and enactment of subordinate legislation on bank operations" is the responsibility of the CNB.

152. The *Central Bank Law* sets out the procedures for appointment, terms of office and criteria for removal as well as broad modalities of accountability for the CNB. The law does not directly specify modalities of accountability related to banking and financial policies, as it only requires reporting to Parliament of information related to price stability and monetary policy (Art. 58). However, the CNB seeks to explain in its Annual Report policies and regulations related to the banking system, and the Annual Report is transmitted to the authorities and made available to the general public.

Open process for formulating and reporting of policies

153. Most transparency practices for an open process for formulating and reporting of banking supervision policies are observed. The *Banking Law* and the Central Bank Law contain a number of provisions and prohibitions for banks in general. The *Banking Law* specifies measures and sanctions to be taken by the CNB with respect to banking supervision and establishes criteria for granting and revoking a bank license. Both laws also establish criteria of incompatibility and define conflict of interest between staff and managers of the CNB and staff and managers of banks.

154. Specific decisions and regulations and forms issued by the CNB are published in the national gazette and in the Banks Bulletin. The Banks Bulletin, started in March 2001, is issued twice a year and provides comprehensive information and insight into developments in the entire system and its present situation. Decisions taken by the CNB that result in significant changes in banking supervision are announced through press releases and the media immediately after the meeting of the Board of Directors. The press releases normally also explain the underlying rationale for such supervisory decisions. Instructions on how to implement the technical changes are distributed to all relevant parties. The CNB seeks regular consultations with market participants regarding technical changes in financial regulations. The Bankers Association and individual banks, for example, are contacted to provide opinions and comments. The CNB also distributes draft regulations to banks and holds meetings with them. The *Banks Bulletin* also includes discussions of future developments of banking regulations and supervision.

Public availability of information on financial policies

155. The *Banks Bulletin* contains: (i) analysis of changes and trends in banking regulations and supervision; (ii) data on the aggregate banking system and on peer groups; and (iii) some bank specific information, such as list of members of banks’ management boards, supervisory boards, shareholders and auditors. The *Bulletin* is published and also posted on the CNB’s website.

Accountability and assurances of integrity by financial agencies

156. Good transparency practices regarding accountability and assurances of integrity by the CNB are broadly in observance. While the *Central Bank Law* does not explicitly specify the modalities of accountability related to banking and financial policies—the requirement for reporting to Parliament only pertains to information related to price stability and monetary policy (Art. 58)—in the CNB’s Annual Report policies and regulations related to the banking system are explained.

Table IV.2. Main Findings of Assessment of Observance of MFP Transparency Code—Banking Supervision

Subject	Main Findings
V. Clarity of roles, responsibilities and objectives of banking supervisory agencies	Most practices are broadly observed. The broad objectives of banking supervision are only partially defined in legislation.
VI. Open process for formulating and reporting of banking supervisory policies	Most practices are observed. CNB’s own assessment of banking sector performance and developments is not frequent.
VII. Public availability of information on banking supervisory policies	Most practices are observed. No aggregate information is reported on emergency liquidity assistance.
VIII. Accountability and assurance of integrity by banking supervisory agencies	Most practices are observed. Internal governance procedures and Internal Audit Department procedures are not publicly disclosed.

Recommended next steps

The main recommendations to fully observe good transparency practices include: (i) clearly stating in the Annual Report or a separate publication the main objective(s) of banking supervision; (ii) the CNB could aim at regular postings on the website its own assessment of banking sector performance and developments; (iii) provide aggregate information on emergency liquidity assistance, within the limits allowed by confidentiality and privacy of information on individual firms; and (iv) publish its internal governance procedures and Internal Audit Department procedures.

Authorities' response

The CNB was in agreement with the mission's assessment and stressed that it would address most of the issues raised. The CNB, however, considered that its website provided most of the relevant information on banking supervision, including the Central Bank Law and the *Banking Law*, listing of the institutions licensed by the CNB, press releases and important circulars.

C. Transparency of Payment Systems Oversight

Institutional and market structure

157. The CNB directly owns, operates and regulates the Croatian RTGS system, (HSVP) for interbank transactions; the CNB also supervises the Financial Agency (FINA, formerly ZAP). In February 2001, the National Clearing System (NKS) was launched and in April 2002 responsibility for all payment transactions and customer accounts were transferred from FINA to banks. The CNB will supervise the NKS. Some institutions, beside the CNB, also regulate parts of the system, like Croatian Securities Commission (CROSEC) that supervises the securities settlement. A Central Depository Agency has been established as a joint stock company to execute clearing and settlement of securities transactions and operate a dematerialized book-entry registry.

Main findings

Clarity of roles, responsibilities, and objectives

158. The broad responsibilities and objectives regarding the payment systems are set out in the *Law on the Croatian National Bank* in the new *Domestic Payment System Law* adopted in December 2001 and supporting regulations. According to the *Central Bank Law*, article 4, the CNB is responsible for regulation and supervision of the payment system in Croatia. Also, article 31 states that "the CNB shall regulate and supervise systems for clearing interbank payment transactions and the methods of settling banks' accounts on the basis of the payments executed through the interbank system. The CNB shall issue licenses for the operation of the interbank payment system, decide on parties participating in and payments executed through them, and determine or approve fees for payments executed through such system."

159. The general objectives of CNB supervision are stated in the year 2000 Annual Report, Chapter 6, where "minimizing system risk in payment operations, achieving a better liquidity management of banks and their customers as well as better liquidity management of the entire banking and financial system, breaking up the monopoly on payment operations, establishing a modern system of payment operations, based on recommendations on payment operations given by the EMU and compatible with the system found in more developed countries" are mentioned.

Open process for formulating and reporting of policies

160. Policies regarding the payment system are transparent. The authorities have implemented systems adopted in advanced economies which have been discussed with market participants and communicated to the general public. Simultaneously, operating procedures for the participants to the HSVP and the NKS have been published and posted on the CNB website.

161. Lombard loans are granted according to the “Decision on terms and conditions for granting short-term loans on the basis of pledged securities.” Lombard loans can be used for intraday liquidity, unlike the blocked part of the required reserves. “Operating rules for the participants of the HSVP system” and “Operating rules for participants of the NKS” in Croatian are posted on CNB’s website.

Public availability of information on the financial policies

162. The CNB regularly publishes information on regulatory activity and performance of the payment system in its Annual Report. Additionally, press releases and speeches posted on the website often provide assessment of how the overall objectives are being pursued, and all relevant legislation and regulations are publicly available and on the CNB website. The CNB does not collect statistical information on the payment systems it oversees, and this is a significant missing element.

Accountability and assurances of integrity by financial agencies

163. Accountability and assurances of integrity regarding the oversight of payment systems are in observance of good transparency practices. The Governor of the CNB appears on request before the Croatian Parliament, while senior CNB officials occasionally participate in seminars or discussions. Provisions regarding the CNB’s accountability more broadly are discussed on other sections of this assessment.

Table IV.3. Main Findings of Assessment of Observance of MFP Transparency Code—Payment Systems Oversight

Subject	Main Findings
V. Clarity of roles, responsibilities, and objectives of payment systems oversight agencies.	Practices are observed.
VI. Open process for formulating and reporting of payment systems oversight policies.	Practices are observed.
VII. Public availability of information on payment systems oversight policies.	Practices are broadly observed. The CNB does not collect data on the payment system.
VIII. Accountability and assurance of integrity by payment systems oversight agencies.	Practices are observed. The CNB does not disclose internal governance and audit procedures.

Recommendation and authorities' response

164. The mission recommended that the authorities collect and publish data on the payment system on a regular basis. The CNB was in agreement with the mission's assessment. In the area of payment systems, the CNB website contains a description of the payment system and payment system laws.

D. Transparency of Insurance Supervision

Institutional and market structure

165. The Insurance Company Supervisory Authority (ICSA) is the agency responsible for licensing, monitoring, and supervision of insurance companies and insurance intermediaries. The Ministry of Finance is responsible for revisions to the insurance legislation and the Director of the ICSA is authorized to issue various types of regulations. The broad objectives of the ICSA and the institutional framework are set out in the *Insurance Act*, modified by the amendments and supplements published in the National Gazette, 20/1997, and supporting decisions. The general structure of the insurance industry is discussed in Section I of this FSSA.

Main findings

166. The ICSA only partly observes most of the good transparency practices in the area of insurance supervision, with nonobservance of some important ones. Substantial strengthening of a broad range of good transparency is needed.

Clarity of roles, responsibilities, and objectives

167. Roles, responsibilities and broad objectives of the ICSA, and the institutional framework are set out in the Insurance Act, modified by the amendments and supplements published in the National Gazette, 20/1997, and supporting decisions. The objective of the ICSA is stated in article 56 of the Insurance Act, stating that the ICSA "...issues operating licenses and checks whether insurance companies are operating according to economic principles and the regulations of the insurance profession." The Act also specifies responsibilities, appointment procedures and terms of office for the insurance supervisor, although criteria for removal from office are not stated. Regulations issued by the ICSA are not published anywhere and are only communicated to the insurance companies.

Open process for formulating and reporting policies

168. Most good transparency practices for an open process for formulating and reporting of insurance supervision policies are only partly observed. Although laws are publicly available, decisions by and procedures of the ICSA are not made available in any publication, website, or publicly available annual report; public consultations on technical changes to the

structure of financial regulations are limited. The ICSA submits an annual report of its activity to the Government, but there are no periodic public reports on how the overall policy objectives are being pursued or on the supervisory activity of the ICSA.

Public availability of information on financial policy

169. Most good transparency practices in the area of public availability of information on financial policies in the insurance area are only “partly observed” or “not observed.” There are no periodic public reports with analysis and comments on the developments of the insurance sector, only aggregate sectoral data are published yearly, without any comment, in a report on “The Insurance Market of the Republic of Croatia.” There is no other publication of the ICSA and it does not post its decisions on any official website.

Accountability and assurance of integrity of financial agencies

170. Most good transparency practices in the area of accountability and assurances of integrity by financial agencies in the insurance area are “not observed” or only “partly observed.” The ICSA is accountable to the Government, and submits to it an Annual Report of its activities; however, this report or its summary is not provided to the public. No information about the financial statement or the balance sheet of the ICSA is released. There is no explicit Code of Conduct to prevent conflicts of interest and impose standards on the conduct of personal financial affairs

Table IV.4. Main Findings of Assessment of Observance of MFP Transparency Code—Insurance Regulation and Supervision

Subject	Main Findings
V. Clarity of roles, responsibilities and objectives of insurance regulatory and supervisory agencies	Practices are observed or broadly observed. Regulations issued by the ICSA are not published anywhere and are only communicated to the insurance companies.
VI. Open process for formulating and reporting of insurance regulatory and supervisory policies	Most practices are partly observed. Decisions by and procedures of the ICSA are not made available in any publication. The process of consultation in the formulation of policy is rather weak and appears to be limited. There are no periodic public reports on how the overall policy objectives are being pursued or on the supervisory activity of the ICSA.
VII. Public availability of information on insurance regulatory and supervisory policies	Most practices are not observed. The ICSA does not issue periodic public reports with analysis and comments on the developments of the insurance sector, only aggregate sectoral data are published without any comment.
VIII. Accountability and assurance of integrity by insurance regulatory and supervisory agencies	Most practices are not observed.

	No information about the ICSA's financial statement or the balance sheet is released. The financial statements are not audited by an independent firm. Conflict of interest standards are not specified in the Insurance Act or in any internal regulation.
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Recommended actions

171. Recommendations for improving transparency practices in the insurance area are as follows: (i) allow interested public to have access to the regulations introduced by the ICSA, this could be in the form of a regular publication or on an official website; (ii) in a regular publication provide an assessment of the performance of the supervised sector and description of the activity of the ICSA, including how the objectives of the institution are being pursued; (iii) publish the by-laws of the ICSA and a summary of its balance sheet; and (iv) establish and publish internal procedures to address conflict of interest issues. The current deficiencies in the areas of effective supervision and transparent practices are partly the outcome of limited resources.

Authorities' response

The ICSA expressed reservations on the mission's assessment of its transparency practices and pointed out that each insurance company is obliged to publish a condensed income statement and a balance sheet providing key information to potential customers of an insurance company on its activities. In addition, the ICSA noted that quarterly reviews of its activities are available not only to the interested competent authorities, but also to foreign investors in the insurance market as well as interested persons, either through trade publications or the daily press. The ICSA also added that it provides not only statistical data on the insurance sector, but also brief comments. However, the mission was only made aware of a single newspaper interview and was not provided with material indicating systematic and regular provision of information to the public. The mission also had difficulties obtaining basic documentation, such as a copy of ICSA's previous year's Annual Report.

E. Transparency of Securities Regulation

Institutional and market structure

172. The Securities Commission of the Republic of Croatia (CROSEC) is the agency responsible for securities supervision and regulation. Its broad objectives and the institutional framework are set out in the *Law on the Issuance and Sale of Securities* (National Gazette, 107/1995, 142/98, 87/2000) and supporting regulations. Other laws relevant to the operations of the CROSEC are the following: the Investment Funds Law (National Gazette, 107/1995, 12/1996), the Privatization of Investment Funds Law (National Gazette, 109/1997), the Take-Over Law (National Gazette, 124/97), the Company Law (National Gazette, 111/1993) the Foreign Exchange Law (National Gazette, 91A/1993, 36/1998). The structure of the securities markets is described in Section I of this FSSA.

173. This assessment is based on information available at the time of the September 2001 FSAP mission. At that time a new law had been drafted that addressed certain shortcomings in the legal framework governing CROSEC. A new Securities Law has subsequently been adopted.

Main findings

174. The CROSEC observes most of the good transparency practices in the area of securities supervision and regulation, but there are serious shortcomings in the legal framework. The findings regarding the clarity of responsibilities and objectives, the process of formulation and reporting of policies, availability of information, and accountability and integrity of relevant agencies in the securities market are discussed below.

Clarity of roles, responsibilities, and objectives

175. The *Securities Law* (Art. 4) specifies that the CROSEC is established as an independent entity “to regulate and oversee the issuance of securities and the securities trade” and sets out its responsibilities, as well as procedures for appointment, terms of office, and the broad modalities of accountability of CROSEC members. Criteria for removal from office are only indirectly stated in the Securities Law, and members of CROSEC can be removed for reasons not listed in that law.

176. A ruling of the Constitutional Court, on the issue of withdrawal of licenses by the CROSEC, determined that the CROSEC has no power to revoke licenses, although this power seemed to have been granted in the Securities Law. This raises concern about the power to conduct inspections on the premises of the supervised institutions and for effective supervision of brokerage houses and brokers more generally.

Open process for formulating and reporting of policies

177. Most transparency practices for an open process for formulating and reporting of securities supervision policies are observed. The Securities Law stipulates a number of provisions and prohibitions and specifies the measures and sanctions that can be taken by CROSEC. Regulations are published in the *Official Gazette* and posted on the CROSEC website. The new regulations are also published in the *Annual Report*, and all regulations issued by the CROSEC have been published in the form of a book.

178. The CROSEC tends to discuss extensively substantive technical changes with the Government and financial institutions. A draft of Securities Law was developed with inputs from market participants, academics, and experts. There are no formal procedures for information sharing and consultation between the CROSEC and other domestic organizations, but at international level the CROSEC has signed a Memorandum of Understanding with the Austrian Bundes-Wertpapieraufsicht (Austrian Securities Commission) for cooperation and information sharing.

Public availability of information on financial policies

179. The CROSEC publishes regularly its Annual Report. The Report covers the institutional and legal framework, assignments and organization of the CROSEC, describes its activities during the year, including the text of and comments on the regulations issued, reports on the state of the capital markets and a financial report on the CROSEC. Also the website provides additional information on the legal framework, with English translation of the most important laws and regulations. The CROSEC could also require that rules and regulations related to the Zagreb Stock Exchange and the OTC market and the Central Depository Agency are consistently made available to the public, possibly on their websites.

180. The Commissioners participate in discussions and seminars. Speeches are typically not published, but the Commissioners are quite active in the dialogue with market participants, other supervisory authorities, academics, and experts. The CROSEC has its own balance sheet and publishes financial data on revenues and expenses in the Annual Report.

Accountability and assurance of integrity of financial agencies

181. Accountability and assurances of integrity by the CROSEC are in observance of good transparency practices. Members of the CROSEC regularly appear in front of Parliament and the CROSEC submits to Parliament, after Government approval, its Annual Report. State auditors regularly inspect CROSEC's books. Annually, the State Auditing Agency and the MoF inspectors perform an audit of the financial documentation and internal procedures for the use of financial resources. Standards for the conduct of personal financial affairs of officials and staff of CROSEC are prescribed by the securities law. There is no specific legal protection for officials and staff in the conduct of their official duties.

Table IV.5. Main Findings of Assessment of Observance of MFP Transparency Code—Securities Regulation and Supervision

Subject	Main Findings
V. Clarity of roles, responsibilities and objectives of securities regulatory and supervisory agencies	Practices by CROSEC are broadly observed, however uncertainties in the legal framework have generated confusion on the authority of the CROSEC to perform actions related to its supervisory and regulatory role.
VI. Open process for formulating and reporting of securities regulatory and supervisory policies	Most practices are observed by the CROSEC. Again, however, some uncertainties in the legal framework have caused some decisions by the CROSEC to be reversed in court.
VII. Public availability of information on securities regulatory and supervisory policies	Most practices are observed. Rules issued by the Zagreb Stock Exchange, by the OTC market and by the CDA, and approved by the CROSEC, are not consistently required to be made available to the public.
VIII. Accountability and assurance of integrity by securities regulatory and supervisory agencies	Most practices are observed.

Recommended actions

182. The main recommendations to fully observe good transparency practices include: (i) the CROSEC could decide that rules governing the Zagreb Stock Exchange and the OTC market and the CDA and the rules they issue, related to supervision and regulation of their own members, and approved by the CROSEC itself, should be consistently posted on the website of those organizations; (ii) the CROSEC could publish the agreements on information sharing and cooperation with international institutions and organizations; (iii) the CROSEC could include in the Annual Report financial data on its own assets and liabilities; and (iv) the CROSEC could post on its own website the “Rules for clearing and settlement of the Central Depository Agency.”

Authorities' response

183. The authorities were in agreement with the assessment and plan to address most of the issues raised. The mission commended the authorities for the efforts to launch and expand the authorities' website. The *Annual Reports*, relevant legislation, main circulars and information on the internal structure of the CROSEC are available on the website, many of them also in English. The authorities agree on the need to strengthen further the legal division, given the uncertainties surrounding the current legal framework. A number of transparency deficiencies, can be attributed to a lack of resources.