CROATIAN NATIONAL BANK

Semi-annual Information

on the Financial Condition, the Degree of Price Stability Achieved and the Implementation of Monetary Policy

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HNB

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Publishing Department
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10002 Zagreb
Phone: +385 1 45 64 555
Contact phone: +385 1 45 65 006
Fax: +385 1 45 64 687

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2012

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1 Summary

Adverse economic developments have continued for the fourth consecutive year. Growth-limiting factors include weak foreign demand and deteriorating financing conditions, resulting from unfavourable global trends, as well as weak competitiveness and a harsh business climate. Growth has been further slowed down by the measures necessary to reduce the excessive fiscal deficit. Under such conditions, while maintaining exchange rate and price stability, monetary policy has been focused on sustaining high liquidity in the domestic banking system and reducing regulatory costs affecting interest rates. In cooperation with the Government and CBRD, the CNB has also launched a lending scheme aimed at providing more favourable corporate loans. As regards fiscal policy, fiscal consolidation has primarily been achieved by a considerable improvement in revenues. It should therefore be continued, in particular through cuts in budget expenditures, while changes on the revenue side should primarily be aimed at reducing labour costs. The business climate should also be improved by continuing with public sector restructuring, mitigating legal risks, improving labour market flexibility and implementing other structural reforms with a view to removing the obstacles and creating stimulating conditions for doing business and investing private capital into export and import substitution sectors, the only sustainable growth generators.

After decreasing sharply in the first quarter of 2012 from the last quarter in 2011 due to negative trends in foreign and domestic demand, real GDP held steady in the second quarter. Favourable movements were observed in foreign demand for tourist services and government consumption increased slightly. According to monthly indicators, economic activity continued to stagnate in the third quarter.

Employment edged down in the first half of 2012, continuing the trend in July and August. The Labour Force Survey unemployment rate was as high as 15.5% in the first six months and the youth unemployment rate was three times as high (among EU members, only Spain and Greece have higher rates).

The annual consumer price inflation rate accelerated in the March to May period as a result of a major shock brought about by increases in the VAT rate and household energy prices. The annual inflation rate increased again in August, to 4%, mostly on account of a drought-induced increase in agricultural product prices. The annual core inflation rate (which excludes agricultural product prices and administrative prices) dropped to a low of 1.5% in the first eight months due to weak personal consumption, unfavourable labour market conditions and a decrease in unit labour costs.

The current account balance continued to improve due to the narrowing of the factor income account deficit and an increase in services account revenues, especially high in the second quarter. The trade in goods deficit widened slightly as a result of a fall in exports to crisis-hit neighbouring trading partners.

Financing conditions for domestic sectors were unfavourable in the first quarter of 2012 largely because of the continued negative impact of external financing conditions and high uncertainty and risk aversion in financial markets. However, as financing conditions became more favourable in the second and third quarters, with a significant improvement observed in external financing cost indicators, interest rates on T-bills and short-term loans decreased. Nevertheless, long-term interest rates failed to decline and demand for loans remained poor, with the result that the corporate sector deleveraged moderately and household lending declined further in the first half of 2012. In an effort to prompt a recovery in corporate lending, the CNB, in cooperation with the CBRD and banks, launched a new lending scheme in 2012, facilitating its implementation by reducing the reserve requirement rate from 15% to 13.5% in April.

Foreign capital inflows subsided, but remained positive. The drop in inflows reflected adverse domestic real developments and uncertainties among international investors. Foreign liabilities of banks decreased noticeably, while debt capital inflows were mostly generated by central government and to a smaller extent by private enterprises. Direct foreign equity investments were still extremely modest and mainly included minor projects in tourism, trade and manufacture of food and beverages. After having increased in the first half of the year, external debt fell to EUR 46.0bn in July, which is an increase of EUR 0.3bn from the end of the previous year. However, relative external debt indicators deteriorated due to nominal GDP dropping considerably in the same period.

The central bank continued to pursue its policy of maintaining comfortable liquidity in the monetary system without jeopardising the stability of the domestic currency exchange rate. Given the surpluses in the overall balance of payments generated by the small current account deficit and continued large total capital inflows, the CNB supported exchange rate stability by net foreign exchange purchases. Liquidity levels in the monetary system thus remained strong and money market interest rates were kept low.

CNB total international reserves increased by EUR 0.7bn in the first six months of 2012. The increase stemmed from EUR 0.3bn in net foreign exchange purchases made by the CNB through a purchase of EUR 1.0bn from the government and a sale of EUR 0.7bn to banks. International reserves were in that period also boosted by foreign exchange gains, for gains from changes in the US dollar exchange rate exceeded foreign exchange losses generated by changes in the euro exchange rate. International reserves also expanded on account of the income from their investment.

The annual rates of return on the CNB's euro and dollar portfolios from international reserve investments were 0.34% and 0.38% respectively in the first six months of 2012, whereas the euro-denominated held-to-maturity portfolio generated an annual rate of return of 2.31% in the period under review. Fed and ECB benchmark interest rates stagnated during this reserve management period. However, due to great insecurity in the markets, government bond yield curves for the countries that are traditionally considered the safest, such as the US, Germany, France and Austria, fell to their historical lows, with even negative yields on some issues and maturities.

Continuing negative economic trends notwithstanding, consolidated central government revenues grew by 3.6% in the first seven months of 2012 due to changes in tax legislation and improved tax and contribution collection. Although budgeted to decrease significantly, consolidated central government expenditures grew slightly in the first seven months. As a result of the relatively strong growth of revenues and slight increase in total expenditures and outlays, the overall fiscal deficit decreased by HRK 1.7bn annually, standing at HRK 8.6bn in the first seven months. However, public debt grew much faster than in the first seven months in 2011, boosted by the shipyards' loan liabilities assumed by the government. Consequently, central government debt reached HRK 174.7bn (52.4% of GDP) at end-July 2012.

The ongoing economic crisis and instabilities in the euro-zone led to a slowdown in domestic banks' operations. Following a slight recovery in growth rates in 2010 and 2011, bank assets dropped by HRK 3.9bn (1.0%) in the first half of 2012. Although they were conducive to freeing up a substantial amount of immobilised funds and led to a reduction in regulatory costs, CNB measures failed to boost lending growth to a great extent due to banks' increased cautiousness, credit risk aversion and weak domestic demand.

The quality of placements deteriorated further as a result of a decrease in the base and the ageing of the portfolio, with the result that the share of partly recoverable and fully irrecoverable loans went up from 12.4% in late 2011 to 13.3% late in the second quarter of 2012. Corporate loan quality continued to deteriorate at the fastest pace, with the non-performing to total loans ratio up from 20.1% to 22.8%. Household loan quality also declined: the same ratio increased from 8.6% to 8.9%, particularly because of home loans denominated in Swiss francs. With the exception of so-called other loans, all household loans decreased.

In the first half of 2012, banks' pre-tax profit was HRK 2.1bn, which is a decline of 15.2% from the same period in 2011. Due to a decrease in net operating income, coupled with an increase in loan loss provisions, bank profitability indicators deteriorated: ROAA declined from 1.2% at end-2011 to 1.1% at end-June in 2012 and ROAE was down from 6.9% to 6.3% in the same period.

The capital adequacy ratio of banks was 20.17% at the end of the second quarter of 2012, its highest value since the end of 2000. The increase was primarily due to a slowdown in operations and a resulting drop in net exposure weighted for credit risk, and in a smaller degree to the inclusion of almost one half of retained earnings from 2011 in the calculation of own funds. At the end of the observed period, all banks had capital adequacy ratios greater than the prescribed minimum of 12%.

2 International environment

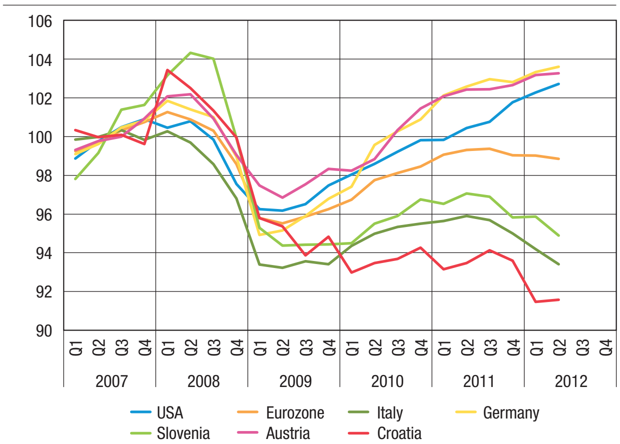
The global economic recovery was slow and uneven in the first half of 2012. After a slowdown in the second quarter, monthly indicators suggested a stabilisation in the global economies in the middle of the year, although with no clear signs of recovery. This unfavourable economic situation was due not only to the absence of a recovery in the eurozone but also to a slowdown in world trade, and, consequently, in emerging market economies and developing countries, especially China and India.

With the debt crisis in the peripheral eurozone countries weighing heavily on the eurozone economy, the expected economic recovery has failed to materialise. Real GDP stagnated in the first three months of 2012, before decreasing by 0.2% in real terms in the second quarter from the first quarter. A slight increase in net exports and government consumption proved insufficient to offset the negative impact of changes in inventories and other domestic demand components. According to available short-term economic indicators, economic activity remained weak in the third quarter.

The economies of the USA and Japan grew in the first half of the year, with a slowdown in real activity observed in the second quarter, notably in Japan. The economic growth in the US continued from 2011 to the first half 2012. Economic activity slowed down slightly in the second quarter from the previous three months, mainly due to a downturn in the growth of personal consumption and investment spending, while budgetary spending continued to decline because of legal restrictions. Having stagnated in the last quarter of 2011, the Japanese economy gathered considerable momentum in the first quarter of 2012 on the back of a boost in personal consumption, partly stemming from the re-introduction of the eco-car subsidy programme and a step-up in public sector investments. The economic activity slowdown in the second quarter was due to stagnation in personal consumption as a result of these subsidies being used up and from subdued foreign demand.

In the first half of 2012, China's annual growth slowed to one of its lowest rates since the outbreak of the global financial crisis. Part of the slowdown was due to the deceleration of foreign demand in the eurozone and the USA and part resulted from the country's inflation control measures and excessive growth of real estate prices. Pursuing an expansionary monetary policy, the Chinese government reduced key interest rates and the reserve requirement rate twice in the first six months. India was also hit by the global slowdown in the first six months of 2012, with a decrease in annual growth rates coupled with a relatively high inflation rate and depreciation of the domestic currency. The deceleration of growth was not only due to weak foreign demand but also to a slowdown in personal consumption and investments.

Figure 1 Gross domestic product of selected economies
seasonally adjusted data, constant prices, 2007 = 100



Note: Data for the eurozone refer to EA17.
Sources: Eurostat and CNB.

2.1 Croatia's main trading partners

The economies of most of Croatia's main trading partners declined markedly in the first half of 2012, especially in the second quarter. This had an adverse effect on real sector developments in Croatia. The country's exports to Italy and Slovenia slumped because they have been experiencing severe economic downturns. Positive but slow movements were only observed in trade relations with Austria (goods exports) and Germany (an increase in tourist arrivals in Croatia).

Italy's economic downturn in the first half of 2012 was mainly driven by declines in personal and investment consumption, arising from unemployment growth and wage cuts. The debt crisis and surging interest rates were still considered the main obstacles to the growth of consumer and producer confidence and a possible recovery in real economic activity, which again failed to materialise in the third quarter.

Real economic activity continued to decline in Slovenia, as a result of negative labour market movements and investment contraction during the first half of 2012. Real GDP stagnated in the first quarter of 2012, but fell again in the second quarter. Adverse labour market conditions, coupled with decreases in employment and nominal wages, led to a slump in personal consumption. Investment consumption contracted sharply in the same period after a credit rating downgrade had pushed interest rates higher. The only positive contribution came from the exports of goods and services, which increased from the first quarter, but insufficiently to offset the fall in other demand components.

Positive developments in the German economy resulted from good export performance and strong domestic demand. Despite a slight deceleration in the second quarter, the growth dynamics was in line with the potential growth of the German economy. Exports to non-eurozone countries remained as strong as in the first quarter, whereas exports to eurozone countries stagnated. Favourable labour market trends, accompanied by wage increases positively impacted on household disposable income and improved household confidence, with the result that personal consumption increased. In contrast, investment spending, primarily investments in production facilities and acquisition of capital equipment, slowed down sharply for the third consecutive quarter due to uncertainties prevailing in European markets.

With the stable economic growth continuing in early 2012, Austria's unemployment rate remained the lowest in the eurozone. The favourable developments resulted from a recovery in government consumption and investment growth, with a positive contribution also coming from net foreign demand due to relatively strong export performance. However, economic growth started to decelerate in the second quarter of 2012, as foreign demand made a negative contribution because imports were rising at a slightly increased rate. In addition, personal consumption growth was halted, despite an increase in disposable income and a record high employment rate.

Serbia's real economy growth fell at a decelerated annual rate in the second quarter of 2012. The adverse trends were mitigated because a downward trend in industrial production stabilised gradually, having accelerated sharply in the first three months of 2012, whereas household consumption contracted further. The inflation rate remained among the highest in the neighbouring countries, primarily as a result of a food price increase in the second quarter and also due to domestic currency depreciation.

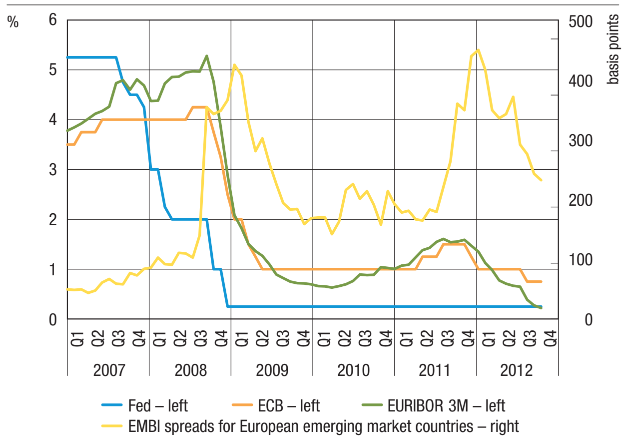
According to trends in industrial production and foreign trade, there was a contraction in economic activity in Bosnia and Herzegovina during the first two quarters of 2012. The contraction eased somewhat in the second quarter on account of improved export performance. Personal consumption fell sharply, pushing down imports of goods, which held steady in the first quarter.

2.2 Benchmark interest rate trends

The European Central Bank adopted a number of crucial decisions during 2012, in order to help stabilise the financial market trends and speed up economic recovery. First, at the turn of 2012, it provided ample liquidity to the eurozone banking system through its long-term bank lending facility[1]. After that, in early July, the ECB reduced its key interest rate by 0.25 percentage points. As a result, the key lending rate fell to a record low of 0.75% and the interest rate on overnight deposits with the ECB dropped to 0%. This was followed by the ECB's announcement of new non-standard monetary policy instruments based on unlimited secondary market purchases of government bonds of the member states which, having limited access to capital markets, use funding from official sources provided through the macroeconomic adjustment programme. As a consequence of these measures, eurozone market interest rates headed lower, dropping very low in late September.

Yields on European emerging market countries' eurobonds fell as financial market uncertainty eased. This downward trend prevailed throughout the first quarter, but was temporarily halted in April and May, on the back of growing uncertainty in financial markets. In the light of expectations that the ECB benchmark rate would soon decrease, the downward trend resumed as early as June and continued in the third quarter, as a result of the ECB's announcement of the purchase of the eurozone member states' government bonds in the secondary market. These developments had a positive effect on yields and CDS spreads on Croatian bonds, which tightened further early

Figure 2 Benchmark interest rates and the average yield spread on bonds of European emerging market countries
end of period



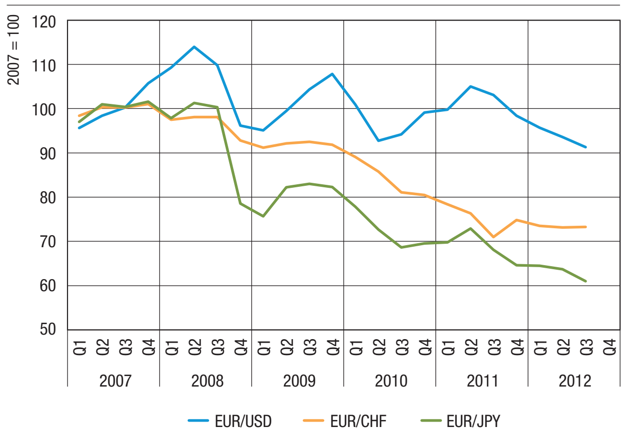
Source: Bloomberg.

in September, when Fitch Ratings revised Croatia's outlook from negative to stable.

2.3 Exchange rates and price developments

The average US dollar/euro exchange rate strengthened in the first nine months of 2012 over its average in the same period last year. Exposed to depreciation pressures, the US dollar ranged from USD/EUR 1.27 to USD/EUR 1.34 in the first two months of 2012. The exchange rate was relatively stable in March and April, before starting to appreciate in early May, due to mounting investor concerns over the eurozone debt crisis. The exchange rate stood at USD/EUR 1.21 at end-July. After that, the dollar started to depreciate again due to a boost in optimism over the financial aid to crisis-stricken eurozone members and expectations that the Fed could begin a new cycle of monetary easing. The end-September exchange rate of the US dollar versus the euro stood at USD/EUR 1.29. The Swiss franc/euro exchange rate was stable in the first nine

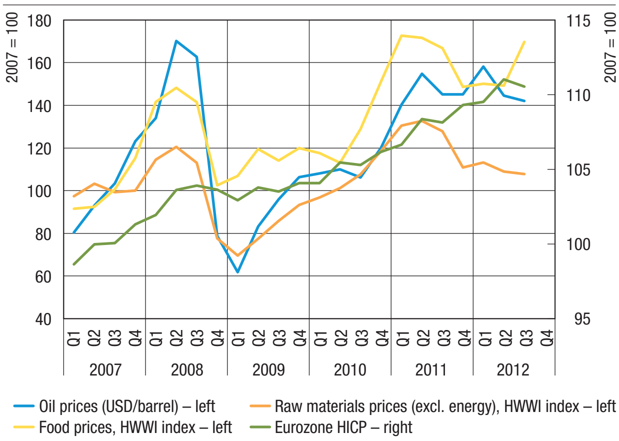
Figure 3 Exchange rates of individual currencies



Note: A growth in the index denotes an appreciation of the euro.
Source: Eurostat.

1 In December 2011 and February 2012, the ECB used a non-standard method to provide liquidity to the banking system through long-term refinancing operations with a maturity of three years, at an interest rate of 1% and with expansion of eligible collateral.

Figure 4 Prices



Note: Data for the third quarter of 2012 refer to July and August only.
Sources: Eurostat, Bloomberg and HWWI.

months of 2012, hovering around the administratively set floor of CHF/EUR 1.20.

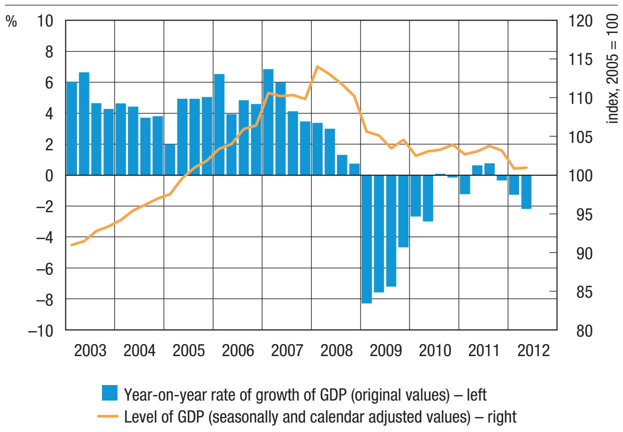
World prices of crude oil were highly volatile in the first three quarters of 2012. They grew modestly in the first quarter, plunging afterwards, but recovering again in the third quarter. An increase in crude oil prices on the world market was seen in the first quarter of 2012, prompted by an agreement among the EU member states on a ban on oil imports from Iran, slightly improved macroeconomic indicators and unusually cold weather in Western Europe. In the second quarter, crude oil prices dropped markedly, primarily due to a potential re-escalation of the debt crisis in the eurozone and its spillover to the rest of the world, as well as a surge in the crude oil supply from the OPEC. In addition, market participants grew more optimistic regarding possible market disorders arising from a decrease in imports from Iran, given the possibility of a release from strategic oil reserves. World crude oil prices rose again in the third quarter, primarily due to renewed tensions with Iran and a drop in supply by OPEC member countries, especially Iran and Angola. In addition, output in non-OPEC members declined on account of strikes, adverse weather conditions and the planned maintenance of oil production plants. The price of Brent crude ranged around USD 113 per barrel in September, which was approximately equal to the previous year's average.

Raw material prices on the global markets, excluding energy, were relatively stable during the first quarter of 2012. An exception to this was the prices of industrial raw materials (textiles, and metal) which dropped, as they were dominantly influenced by concerns over future developments in demand, caused by the global economic slowdown. By contrast, food prices went up, especially the prices of cereals and oil seeds, due to reduced supply from South America caused by bad weather. The growth in the prices of food raw materials (especially those of cereals, oil and oil seeds), caused by a drought in the USA, continued in the third quarter, as did the fall in industrial raw material prices. The HWWI index of raw material prices (excluding energy, in USD) dropped by 1.2% in September from December 2011.

3 Aggregate demand and supply

Real GDP, seasonally adjusted, dropped markedly in the first quarter of 2012 from the last quarter of 2011, due to unfavourable movements in almost all aggregate demand components. In the second quarter, GDP stagnated at the low level of the first quarter, with favourable movements observed in foreign demand for tourist services and a slight improvement in government consumption. Other aggregate demand components continued to contract. Due to these negative trends in GDP in the January-March period, economic activity continued to decline markedly throughout the first half of 2012 relative to the end of 2011.

Figure 5 Gross domestic product
real values



Source: CBS data seasonally adjusted by the CNB.

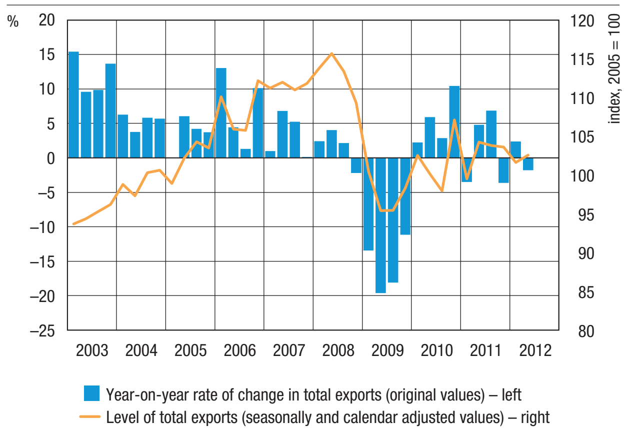
3.1 Aggregate demand

Due to diminishing foreign demand caused by unfavourable economic activity trends in the international environment, goods and services exports fell markedly during the first quarter of 2012. The second quarter, however, saw a slight recovery in the exports of goods and services, primarily due to the strong performance of the tourist industry. Exports of goods declined, with exports of other transport equipment (primarily ships) down the most. July and August saw a better performance, as nominal exports of goods and the number of tourist nights increased.

Household consumption continued to shrink in the first and second quarters of 2012. These movements were mostly due to a fall in disposable income and continued deleveraging by households. Increases in the general VAT rate and household electricity and gas prices also produced a negative impact on consumption in this period. As shown by the results of a consumer confidence survey, consumer optimism waned in the same period, thus probably reducing any propensity to consume from disposable income. Household demand for loans remained subdued due to uncertainty about future economic and labour market developments.

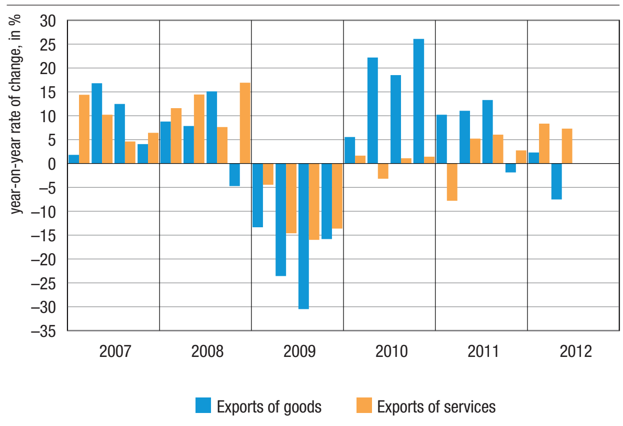
Capital investments also continued to contract in the first and second quarters, following their slightly more favourable performance during the second half of 2011. Public sector investment was adversely affected by the provisional budget financing during the first quarter. Moreover, the handover of power had a negative effect on the investment activity of companies in majority state ownership, as evident from the slowdown in the realisation of the announced investment plans. Despite the limiting effect of the budgetary expenditure ceiling on the government's investment activity, capital investments at the consolidated general government level increased slightly in the second quarter, as suggested by fiscal cash data. Private sector investments continued to decline, as the crisis in the construction sector persisted. Moreover, low aggregate demand and uncertain economic prospects discouraged any substantial investment in production facilities, which was reflected in import dynamics and, to some extent, in capital goods production.

Figure 6 Exports of goods and services
real values



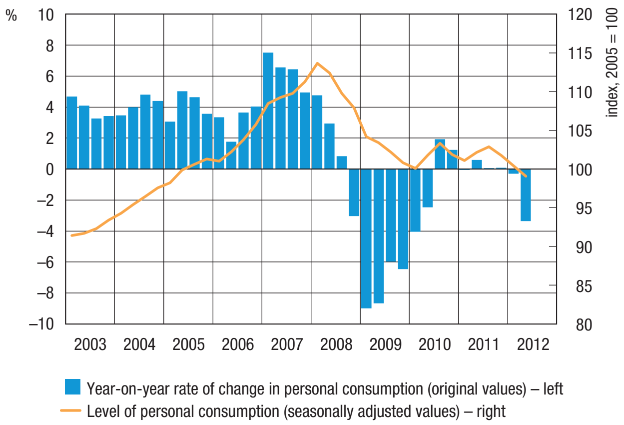
Source: CBS data seasonally adjusted by the CNB.

Figure 7 Nominal exports of goods and services



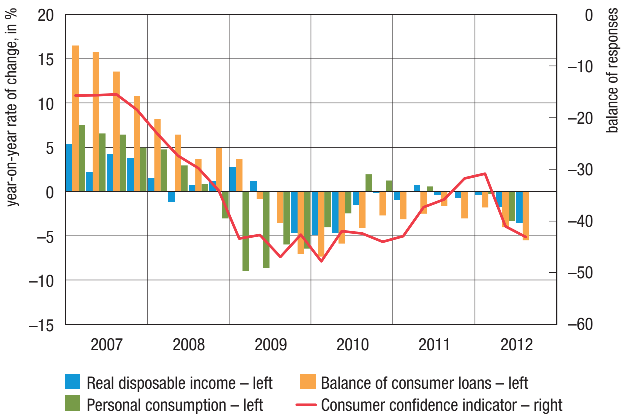
Source: CNB.

Figure 8 Personal consumption
real values



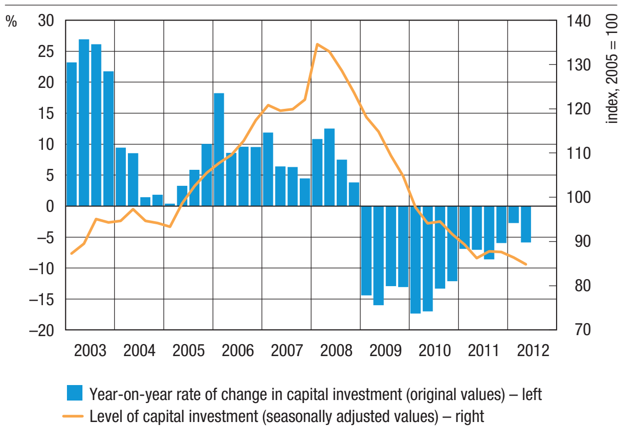
Source: CBS data seasonally adjusted by the CNB.

Figure 9 Determinants of personal consumption



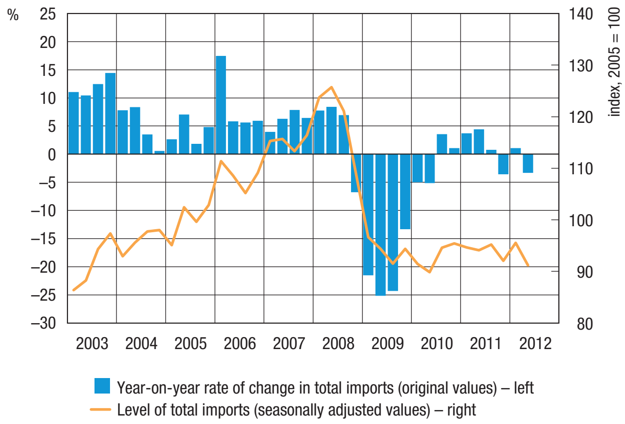
Note: The values of the consumer confidence indicator in a month are calculated as averages of monthly data.
Sources: CBS, Ipsos Puls and CNB.

Figure 10 Gross fixed capital formation
real values



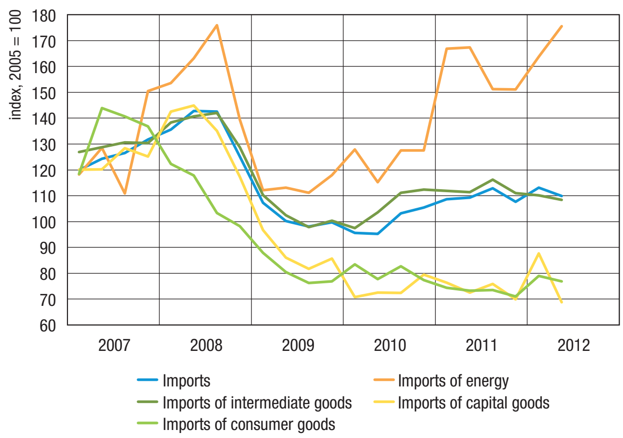
Source: CBS data seasonally adjusted by the CNB.

Figure 11 Imports of goods and services
real values



Source: CBS data seasonally adjusted by the CNB.

Figure 12 Nominal goods imports by category
seasonally adjusted

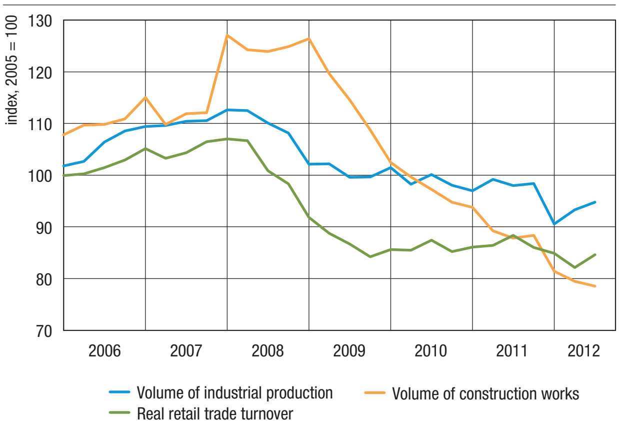


Source: CBS data seasonally adjusted by the CNB.

Government consumption improved in the second quarter, after a decline early in the year, caused by legal restrictions. This was mostly due to an increase in spending on goods and services. The number of civil servants and government employees at the end of the second quarter remained unchanged from end-2011.

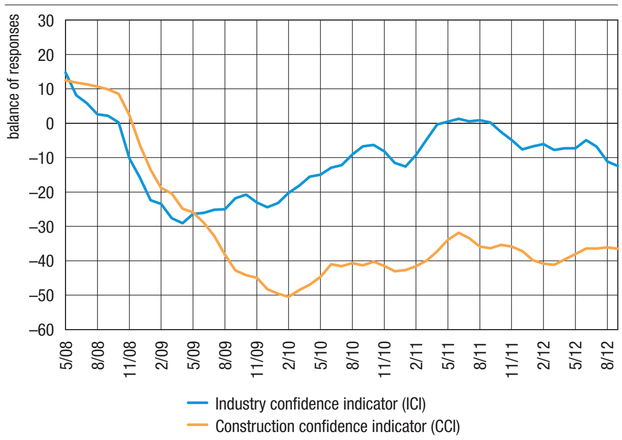
Despite these negative changes in domestic demand, goods imports went up in the first quarter. This was largely the consequence of a surge in the imports of other transport equipment, the dynamics of which are not closely related to the current aggregate activity, and of the effects of oil price growth. Further contraction of most domestic demand components led to a decrease in the imports of goods and services during the second quarter. This was mostly due to a fall in the imports of goods (primarily capital and intermediate goods), while imports of services rose slightly.

Figure 13 Short-term economic indicators
seasonally and calendar adjusted



Source: CBS data seasonally adjusted by the CNB.

Figure 14 Business confidence indicators
three-member moving averages of monthly data



Source: Ipsos Puls data seasonally adjusted by the CNB.

3.2 Aggregate supply

Real gross value added decreased markedly in the first quarter of 2012 from end-2011, which was in line with negative changes in aggregate demand. Stagnant trends in GVA for most activities during the second quarter led to stagnation in current aggregate supply during that period. These aggregate supply trends were corroborated by the results of a business confidence survey made in the first half of 2012.

The available data give very little information about economic developments in the third quarter of 2012. Real retail trade turnover and industrial production volume strengthened in July and August from the previous quarter's averages and the number of tourist nights also increased annually. However, given the fall in business confidence observed in the third quarter and the high degree of global uncertainty, it would be premature to talk about a third-quarter economic recovery.

4 Labour market

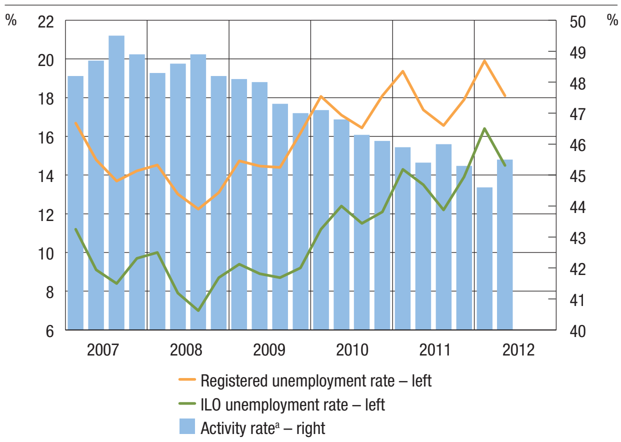
Employment fell slightly in the first half of 2012, and similar trends continued through July and August. A temporary slight increase in the number of employed persons was only observed in the second quarter, due to good tourist pre-season results and continued hiring in the public sector. In view of the negative economic activity movements during the reference period, the sharpest decline in the number of employed persons was seen in construction and industry.

According to seasonally adjusted CES data, the number of the unemployed increased during the first half of the year, and the upward trend continued into the third quarter of 2012. In line with the movements in the number of employed and unemployed persons, the average unemployment rate, seasonally adjusted, stood at 18.4%, but went up to 19.0% during July and August. The Labour Force Survey results for the first six months of the current year also suggest an exceptionally high unemployment rate in this period (14.4%, seasonally adjusted).

Nominal gross and net wages stagnated in the first half of the year, but declined slightly during July and August. Real wages decreased as early as the first half of the year, and continued to fall in July and August relative to the previous quarter, although at a slightly slower pace. This was due to favourable trends in prices, which more than offset the slightly unfavourable nominal wage dynamics.

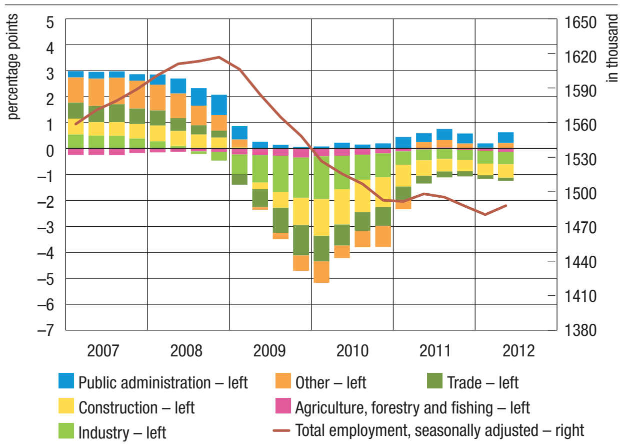
Nominal unit labour costs went up during the first quarter, primarily due to a contraction in economic activity during the period. The second quarter saw a fall in unit labour costs, attributable to labour costs undergoing a sharper drop than labour productivity. As the level of prices increased, the real unit labour costs fell throughout the first six months, easing the cost pressures on inflation.

Figure 16 Unemployment and activity rates



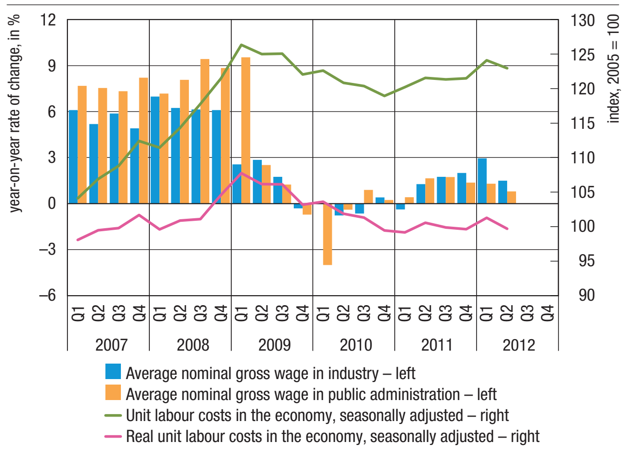
[a] The labour force as a percentage of working age population (15+).
Sources: CBS and CES.

Figure 15 Total employment and contribution to employment growth by sector



Source: CPIA data seasonally adjusted by the CNB.

Figure 17 Gross wages and unit labour costs



Sources: CBS and CPIA data seasonally adjusted by the CNB.

5 Inflation

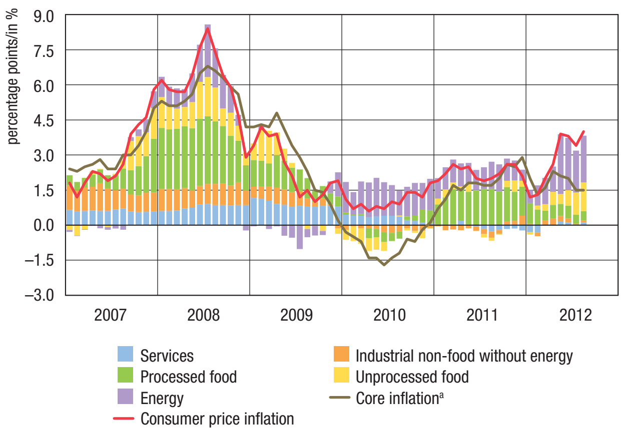
Consumer price inflation dropped sharply in early 2012 against a background of weak domestic demand, unfavourable labour market conditions and an annual decrease in non-energy raw material prices. The annual consumer price inflation rate fell from 2.1% in December 2011 to 1.3% in February 2012, primarily due to a decrease in the annual rates of change in the prices of processed food products and non-food and non-energy industrial products (especially clothing). Energy price growth produced an opposite effect on consumer price inflation.

The annual consumer price inflation rate accelerated significantly in the March to May period, reaching 3.9% in May, mainly due to administrative increases in the basic VAT rate from 23% to 25% in March[2] and in electricity and gas prices in May.[3] Locally regulated prices (e.g. water supply and public transport) also increased sharply in March. In contrast, the contribution to inflation of processed food products decreased, mainly because of the cut in the basic VAT rate on oil and fats, sugar and baby food from 23% to 10%. Amid weak demand, the annual rates of change in services prices and non-food and non-energy industrial products prices remained very low, dipping below 1% in May.

After the shock caused by increases in the VAT rate and household energy prices, monthly overall inflation rates (seasonally adjusted and annualised) came down in the June to August period. The annual overall inflation rate, after a two-month slowdown, increased to 4.0% in August, primarily due to a supply-side shock, i.e. a price increase in unprocessed food products (fruit and vegetables), caused by a drought-induced crop failure. In addition, refined petroleum products and communication services considerably increased their contributions to annual inflation in August, the former due to an increase in world crude oil prices and the latter on account of an unfavourable base effect, stemming from a fall in these services prices in the same period in the previous year.

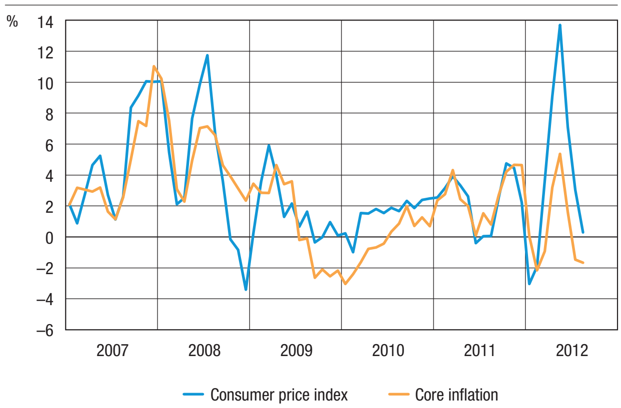
Inflationary pressures were mitigated by domestic factors, above all by weak personal consumption, unfavourable labour market conditions and a decrease in unit labour costs.[4] This can be observed in developments in the annual core inflation rate (which excludes agricultural products and administrative prices)[5], for it dropped from 2.3% in April to 1.5% in July,

Figure 19 Year-on-year inflation rates and contribution of components to consumer price inflation



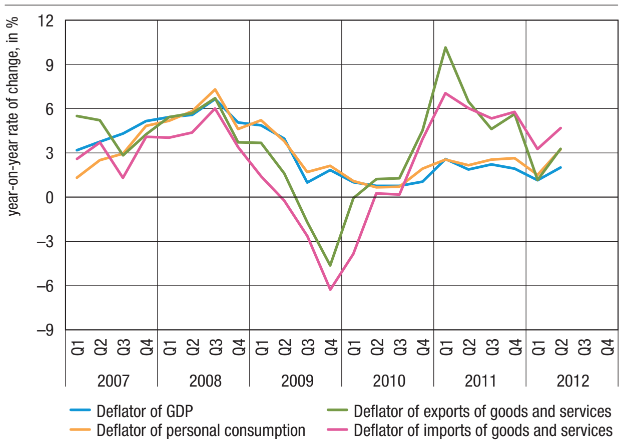
[a] Core inflation excludes agricultural product prices and administrative prices.
Sources: CBS and CNB calculations.

Figure 18 Consumer price index and core inflation
annualised month-on-month rate of change[a]



[a] The month-on-month rate of change is calculated from the quarterly moving average of seasonally adjusted price indices.
Sources: CBS and CNB calculations.

Figure 20 Deflator of GDP and its individual components



Source: CBS.

2 The changes in the VAT system made an estimated net contribution to monthly inflation of 0.7 percentage points in March.
3 The increase in electricity and natural gas prices contributed 1.5 percentage points to monthly inflation in May.
4 Recorded in the second quarter compared with the previous quarter and triggered by a reduction in health insurance contributions.
5 A core inflation indicator facilitates an analysis of consumer price developments in that it enables a clearer distinction to be made between the contributions to the overall consumer price growth of components whose trends are largely outside the control of monetary authorities (agricultural products, administrative prices, including energy product prices) from the contributions to the growth of prices considered to stem mainly from demand-side pressures.

holding steady at this level in August, primarily on account of a decrease in the annual rate of change in the prices of industrial products (clothing) and processed food products. The annualised monthly rate of change of core inflation turned negative in July and August, indicating that domestic inflationary pressures had subsided.

The implicit deflator for imports of goods and services accelerated annually in the second quarter of 2012, suggesting an increase in imported inflationary pressures. The deflator for exports of goods and services increased at a relatively slower annual rate, with the result that foreign trade conditions deteriorated annually in the second quarter. The annual rates of change in the deflators for personal consumption and GDP rose in the same period.

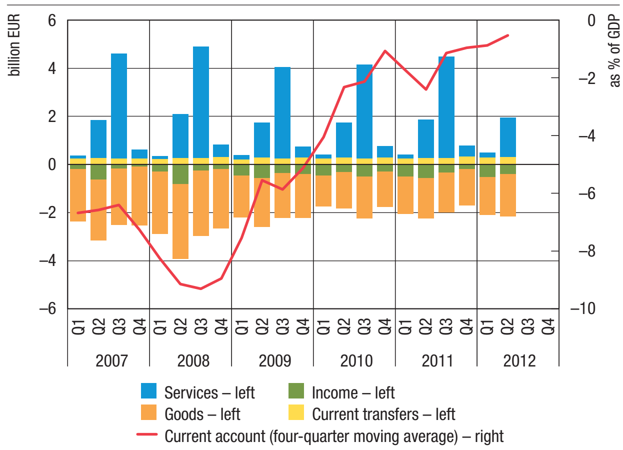
6 Foreign trade and competitiveness

The current account balance continued to improve in the first half of 2012. The EUR 1.8bn deficit contracted by 9.7% from the same period in 2011 due to an unexpected narrowing of the factor income deficit and a growth in service revenues. The trade in goods deficit widened slightly as a result of a drop in exports to crisis-hit trading partners, in particular Italy and Slovenia.

The factor income deficit decreased in the first half of 2012 due to a decline in the business performance of several foreign-owned enterprises and banks. Direct investment expenditures, after having dipped early in the year, decreased annually by EUR 0.2bn in the second quarter. The weaker business results of enterprises owned by non-residents were mainly related to the production of refined petroleum products and chemical products and in financial intermediation, while business results achieved in other activities were generally better than in the previous year. The annual growth in interest expense slowed down in the second quarter from the first three months of 2012, but mainly as a result of stepped-up central government foreign borrowing. Other sectors' external financing costs declined slightly in the second quarter on the back of decelerated debt growth and a small improvement in the financing conditions in foreign markets. The service trade surplus continued to expand in the second quarter of 2012, boosted primarily by an annual rise of 9.1% in tourism revenues, for the most part due to an increase in the number of nights spent by German tourists. The positive balance in the current transfers account continued to rise, the increase stemming from a growth in private sector revenues.

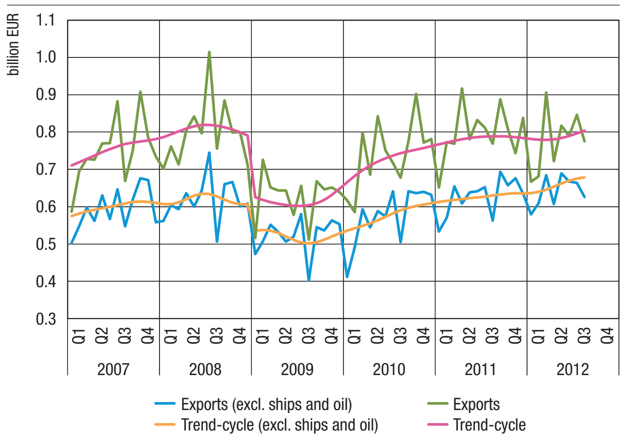
The weakening of foreign demand had a negative effect on domestic exports. Exports of goods stagnated in the first three months of 2012, before decreasing at a quarterly rate of 1.8%

Figure 21 Current account balance and its structure



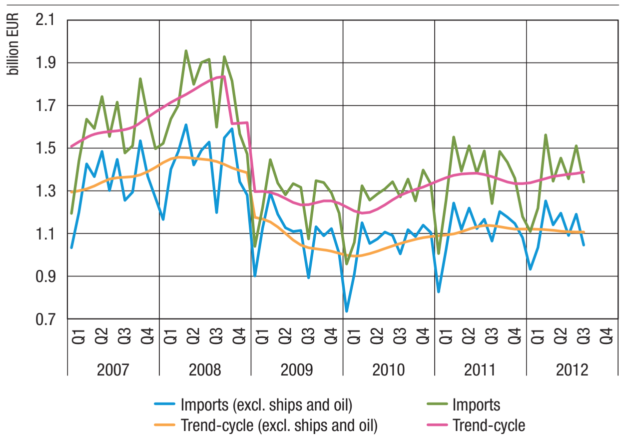
Source: CNB.

Figure 22 Goods exports (f.o.b.) and trend-cycle



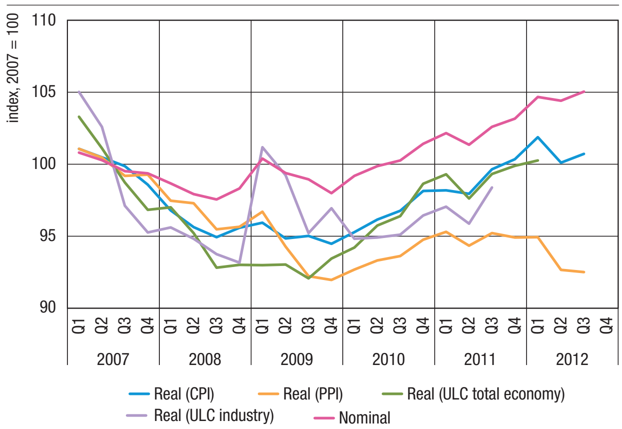
Note: Data for the third quarter of 2012 refer to July and August only.
Source: CBS data seasonally adjusted by the CNB.

Figure 23 Goods imports (c.i.f.) and trend-cycle



Note: Data for the third quarter of 2012 refer to July and August only.
Source: CBS data seasonally adjusted by the CNB.

Figure 24 Nominal and real effective exchange rates of the kuna



Note: A fall in the index denotes an effective appreciation of the kuna. Data for the third quarter of 2012 refer to July.
Source: CNB.

in the second quarter, according to seasonally adjusted data. Low ship exports made a substantial contribution to the continuation of the unfavourable trend. The growth rate of exports in the narrow aggregate (ships and oil excluded) increased from 1.5% in the first three months to 3.1% in the second quarter. Exports of non-monetary gold, natural and manufactured gas, cereal and cereal preparations and of some capital goods rose at the highest rate in the first six months of 2012 from the second half of 2011. Apart from ship exports, exports of iron and steel, metalliferous ores and metal scrap also showed negative trends. However, exports in the narrow aggregate decreased again in July and August (–1.9% from the second quarter average). Nevertheless, as a result of an increase in exports of ships and refined petroleum products, total exports went up by 3.7% in July and August.

Adverse developments in imports of goods reflected the weakening of domestic economic activity. Imports recovered in the first three months of 2012, before dropping again by 1.0% in the second quarter (according to seasonally adjusted data). The recovery early in the year resulted from high imports of ships for the purpose of finishing and from strong gas and electricity imports, with the latter slowing down subsequently. The negative trend in the second quarter was also driven by a fall in imports of road vehicles that followed after a stagnation in the first three months. Imports strengthened again in July and August (2.9% relative to the second quarter average), mainly on account of ships finished abroad and returned to domestic shipyards (thus imported) and higher imports of oil and refined petroleum products. The growth in imports of other goods was more moderate (imports excluding ships and oil rose by 1.3% on a quarterly basis).

Indicators of export price competitiveness showed diverse trends in 2012. The real effective kuna exchange rate deflated by consumer prices depreciated in the first half of 2012 from the previous half of the year as a result of the depreciation of the nominal effective kuna exchange rate in the first quarter. After appreciating slightly in the second quarter, the real effective kuna exchange rate deflated by consumer prices depreciated slightly at the beginning of the third quarter. In contrast, the real effective exchange rate of the kuna deflated by producer prices appreciated semi-annually since movements in domestic prices were less favourable than in most of the major trading partners. Similar trends continued early in the third quarter. According to the latest available data for the first quarter of 2012, the real effective kuna exchange rate deflated by unit labour costs for the economy as a whole continued to depreciate.

7 Financing conditions and capital flows

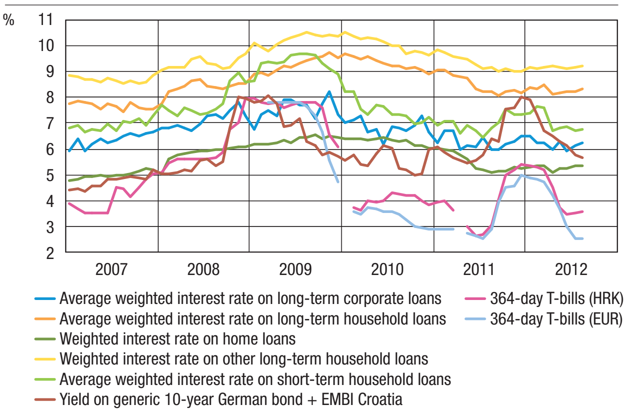
Financing conditions for domestic sectors were unfavourable in the first quarter of 2012, but the second and third quarters saw financing costs decrease due to improved trends. External financing costs indicators improved noticeably, while domestic costs dropped significantly only for T-bills and short-term loans.

Yield spreads on Croatian bonds and CDS spreads for Croatia were extremely volatile in 2012, reflecting tensions in European financial markets. Starting to decrease gradually at mid-year, these indicators contracted at a sharper pace in the third quarter as the ECB embarked upon new non-conventional monetary policy measures that significantly reduced the uncertainty in European financial markets. Croatia's CDS spread was almost 200 basis points lower at end-September than at the beginning of the year, which could also be attributed to Fitch revising upwards the outlook on Croatia's credit rating. Measured by the same indicator, financing conditions also improved for domestic banks' parent banks.

More favourable developments in the international environment were reflected in the movements of domestic short-term interest rates. Government financing costs at T-bill auctions and interest rates on short-term corporate loans were more favourable at the beginning of the third quarter than early in the year. However, interest rates on long-term loans remained almost unchanged. In the second quarter, only interest rates on home loans decreased slightly, but such movements were temporary and reflected the influence of loans granted under a special programme of the Government of the Republic of Croatia.

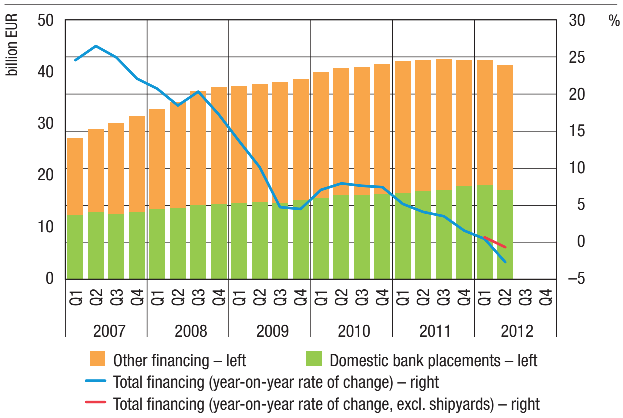
Due to the absence of any fall in long-term interest rates under conditions of poor demand for loans and unfavourable real developments, the corporate sector deleveraged

Figure 25 Costs of domestic and foreign financing



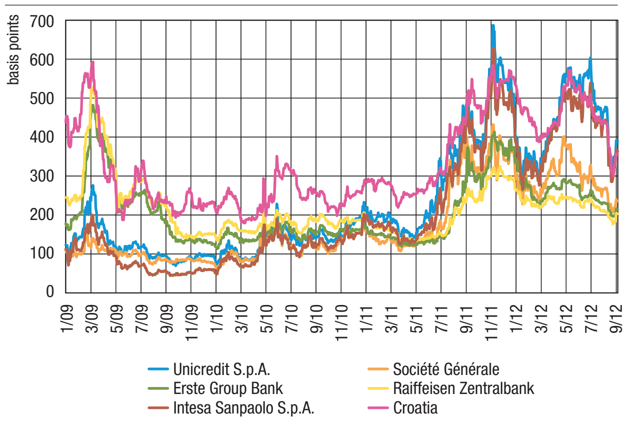
Note: EMBI (Emerging Market Bond Index) is the spread between yields on government securities of emerging markets, including Croatia, and risk-free securities of developed countries.
Sources: Bloomberg, MoF and CNB.

Figure 27 Corporate financing by sources



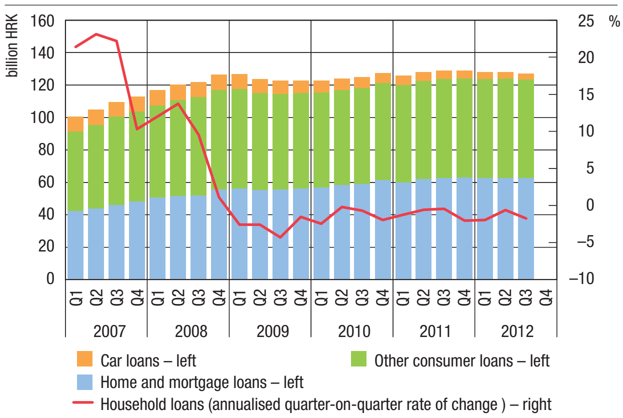
Note: Other financing includes corporate borrowing from domestic leasing companies and direct borrowing from the CBRD, as well as borrowing from foreign banks and affiliated enterprises abroad.
Sources: HANFA (CNB calculations) and CNB.

Figure 26 CDS spreads for Croatia and selected parent banks of domestic banks



Note: Credit default swaps (CDS) spread is an annual premium that a CDS buyer pays for protection against credit risk associated with an issuer of an instrument.
Source: Bloomberg.

Figure 28 Household loans by purpose



Note: Quarter-on-quarter rates of change in loans are calculated from values excluding the exchange rate effect. The most recent data available refer to August 2012.
Source: CNB.

moderately in the first half of 2012, recording a slight decline in debt to domestic banks and a fall in debt in other domestic and foreign financing. At end-June, the annual change in total corporate sector debt thus turned negative, even if the effect of the MoF's assumption of shipyards' loan liabilities is excluded, with the result that the stock of domestic corporate loans decreased considerably in 2012.

Household loans continued to decrease in 2012 reflecting adverse conditions in the economy, and on the labour market in particular, and weak demand for loans. Car purchase loans decreased at the sharpest rate, while home loans, accounting for the largest share in household loans, continued to stagnate.

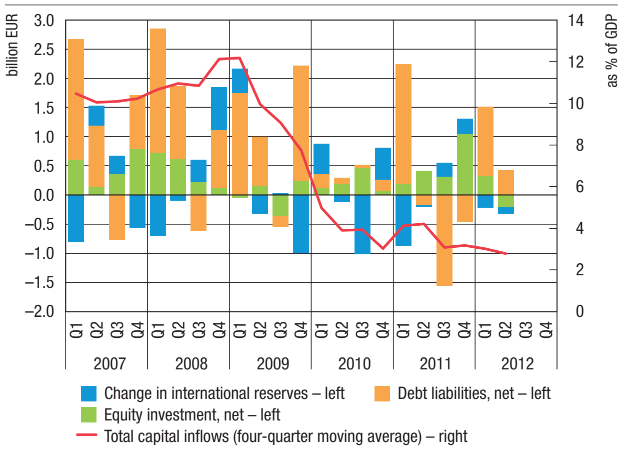
7.1 Foreign capital flows

Capital inflows fell in the second quarter of 2012 amid adverse domestic real developments and uncertainty on the part of foreign investors. Net foreign capital inflows, excluding the change in international reserves, were EUR 1.7bn in the first half of 2012, down by one third from the same period in 2011. Direct foreign equity investments, mainly including small projects in the tourism industry, trade and food and beverage manufacture, amounted to a mere EUR 42m in the first three months and remained low at EUR 0.1bn in the second quarter. A large portion of foreign capital inflows in the first quarter came because banks divested substantial foreign assets (EUR 0.9bn) to purchase euro T-bills.[6] Central government generated the bulk of debt capital inflows in the second quarter, with the rest accounted for by private enterprises, whereas other sectors mostly deleveraged. A slight growth in foreign liabilities of banks in the first three months was followed by their unexpectedly strong deleveraging in the second quarter, facilitated by a sharp increase in domestic financing sources under conditions of poor credit activity.

The deterioration in the net external position in the first half of 2012 was the most severe in the government sector. Net inflows of debt capital amounted to EUR 1.6bn in the first six months. The net external debt position of the government and private enterprises deteriorated sharply in the second quarter of 2012 as a result of an increase in their foreign liabilities. At the same time, banks improved their net external position by reducing foreign liabilities and increasing foreign assets. After having risen by EUR 0.2bn in the first three months and by another EUR 0.1bn in the second quarter, primarily boosted by foreign exchange purchases from the central government, international reserves (cross-currency changes excluded) amounted to EUR 11.6bn at end-June and were sufficient to cover 7.4 months of goods and services imports.

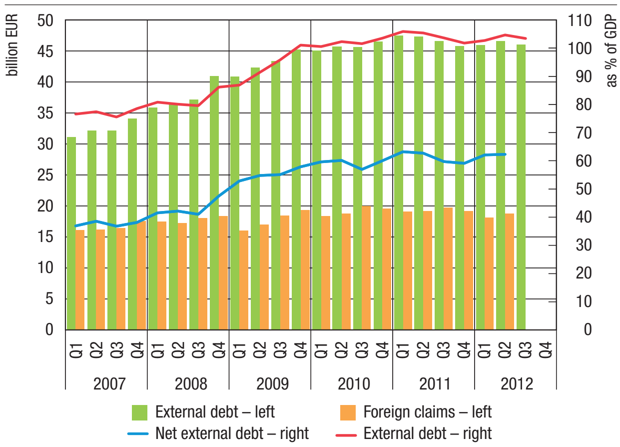
The largest contribution to external debt growth in the second quarter of 2012 came from government and Agrokor d.d. bond issues. Gross external debt rose by EUR 0.2bn in the first quarter and further by EUR 0.6bn in the second quarter. Apart from net transactions, amounting to EUR 0.6bn, this growth was also adversely affected by a weakening of the euro against the US dollar. The increase in debt was mainly due to a government bond issue on the US market (USD 1.5bn) in April.

Figure 29 Current account deficit financing



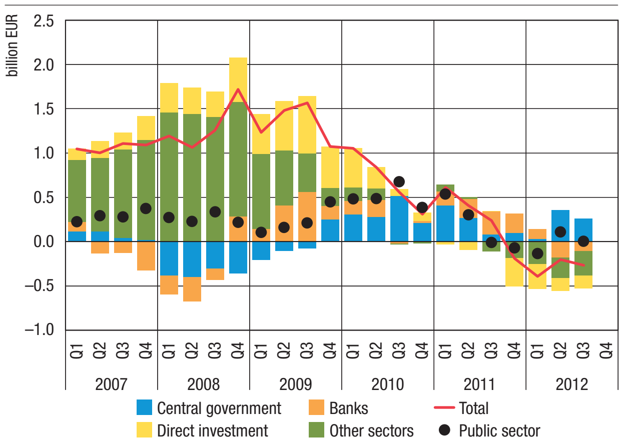
Note: A negative change in international reserves denotes their growth.
Source: CNB.

Figure 30 Gross and net external debt



Note: Data for the third quarter of 2012 refer to July.
Source: CNB.

Figure 31 Domestic sectors' contributions to the quarterly changes in external debt
four-quarter moving average



Note: Data for the third quarter of 2012 refer to July.
Source: CNB.

6 Under the amendments to the CNB's Decision on the minimum required amount of foreign currency claims, foreign currency claims also include the amount of euro T-bills issued at an auction held in February 2012. This enabled banks to invest their foreign assets in MoF T-bills (EUR 764m).

Foreign liabilities of private enterprises increased slightly in the first three months, with a steep increase in debt in the second quarter primarily resulting from a EUR 0.3bn foreign bond issue by Agrokor d.d. The long-term deleveraging trend of non-banking financial institutions continued through the first three months of 2012, before halting temporarily in the second quarter due to a small increase in foreign liabilities of non-banking financial institutions. Banks borrowed at a low rate in the first quarter, reducing their external debt by a significant EUR 0.5bn in the second quarter. Deleveraging by public enterprises against foreign creditors intensified in the second quarter, with debt reduced further by EUR 0.3bn worth of shipyards' external debt assumed by the government as part of the shipyard restructuring programme.

July saw continued strong deleveraging by banks and marginal deleveraging by private enterprises and non-banking financial institutions. Thanks to substantial seasonal foreign exchange inflows from tourism, banks deleveraged at a faster rate, reducing their debt by an additional EUR 0.5bn. Foreign liabilities of private enterprises also decreased slightly and non-banking financial institutions deleveraged again to a smaller extent. As a result of these transactions, gross external debt stood at EUR 46.0bn at end-July, down by EUR 0.6bn from end-June. Relative external debt indicators, which had improved in 2011 as a whole, deteriorated again in 2012 (the external debt to GDP ratio rose to 103.4% at end-July).

8 Monetary policy

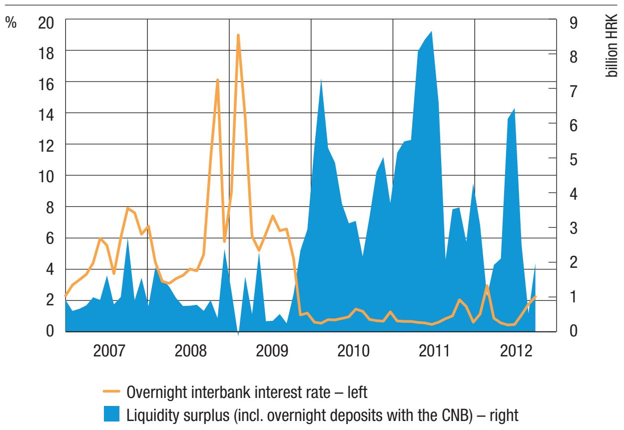
In 2012, the CNB continued its policy of supporting favourable liquidity in the monetary system without threatening the stability of the domestic currency exchange rate. The CNB also continued to back the recovery of credit activity in co-operation with the CBRD and banks.

In order to improve domestic financing conditions, the CNB, in agreement with banks and the CBRD, launched a new loan incentive programme[7] to spur corporate lending. The implementation of the programme started with a reduction of the reserve requirement rate in April, (from 15% to 13.5%); the funds thus released were used by banks for granting loans to the CBRD for joint implementation of the new lending model[8]. The lending potential of the programme is HRK 6.8bn, the CBRD and banks providing equal amounts. In addition, the Croatian National Bank will recognise a half of corporate claims by banks to be realised under the programme as liquid foreign currency claims, which will further reduce the banks' regulatory costs. The first CBRD auction for the quota allocation under this programme was held in June, and three additional auctions had been held by the beginning of October. The total amount of quotas allocated at auctions by mid-October was HRK 2.bn, with interest rates on granted loans being considerably below the market rates.

In the first quarter, the central bank maintained exchange rate stability through its foreign exchange market interventions and by increasing the reserve requirement rate (from 14% to 15% in January). However, this increase was only temporary, as the reserve requirement rate dropped from 15% to 13.5% as early as April. Another contribution to the stability of the domestic foreign exchange market came from an international government bond issue in April. At the end of May, the CNB returned to the market part of the foreign exchange funds raised through purchases from the government. In the third quarter, the monetary situation was marked by a seasonal decline in kuna liquidity and appreciation pressures on the exchange rate, due to a stronger demand for currency during the summer. One of the causes of the slightly reduced liquidity surpluses of banks was the fact that they used the released reserve requirement funds for granting a syndicated loan to the CBRD under the Economic Development Programme (HRK 3.4bn). The funds were deposited in a special account with the central bank. Liquidity was additionally reduced due to a rise in central government deposits with the CNB and the issue of government bonds in the domestic market. Accordingly, interest rates on overnight loans in the money market increased slightly.

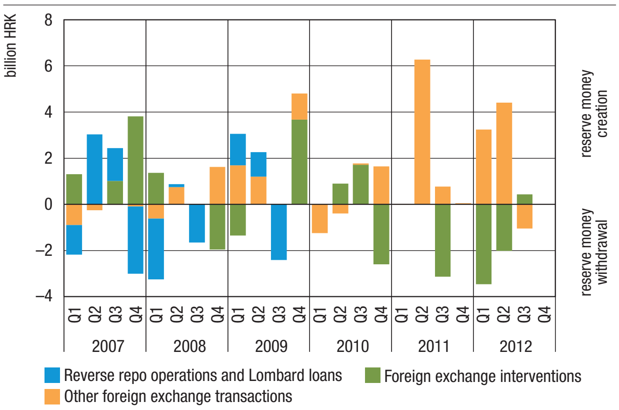
In its total foreign exchange transactions in the first nine

Figure 32 Bank liquidity and overnight interbank interest rate



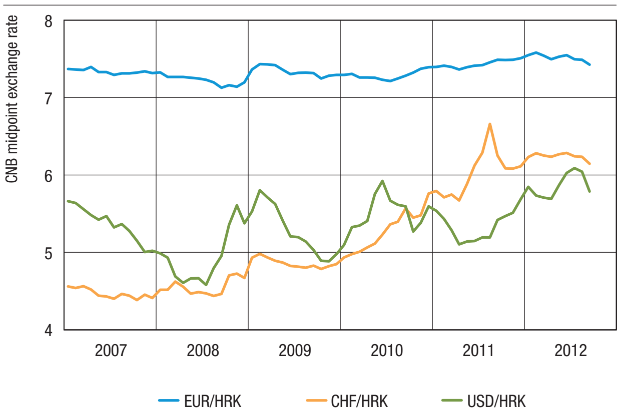
Source: CNB.

Figure 33 Flows of reserve money (M0) creation



Note: Other foreign exchange transactions include the purchase of foreign exchange from and the sale of foreign exchange to the MoF and foreign currency swaps with banks, where the positive values refer to the purchase of foreign exchange by the CNB.
Source: CNB.

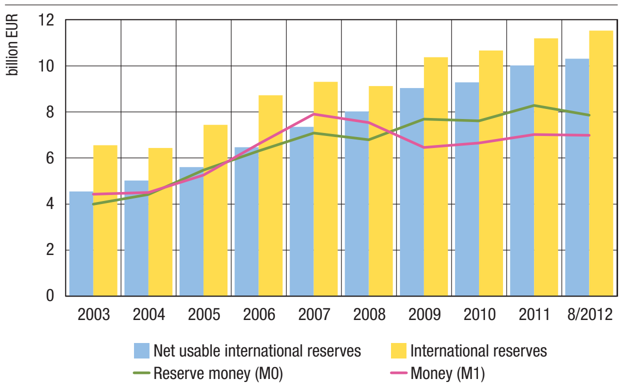
Figure 34 Nominal exchange rates EUR/HRK, USD/HRK and CHF/HRK



Source: CNB.

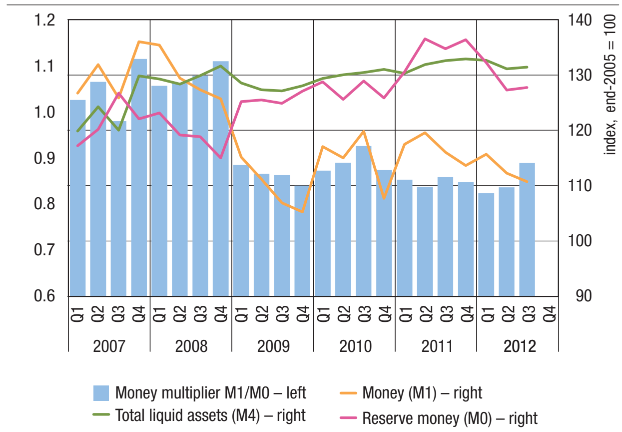
7 Under the loan programme, economic entities with development potential are defined as potential loan users that generate at least 10% of their income from the sale of goods/services in the international market and are at least 25% privately owned as at the date of the loan application. In addition, companies need to meet certain liquidity, indebtedness and profitability criteria.
8 As in the case of the A and A+ models, implemented in 2010, and 2011.

Figure 35 International reserves of the CNB and monetary aggregates



Note: Net usable international reserves are defined as international reserves net of foreign liabilities, reserve requirements in f/c, general and special SDR allocations in 2009, government foreign currency deposits and off-balance sheet iabilities (swaps). The most recent data available for M1 refer to the end of August 2012.
Source: CNB.

Figure 36 Monetary aggregates and money multiplier
index of developments in seasonally adjusted values, deflated by the consumer price index



Note: The most recent data available refer to the end of August 2012.
Source: CNB.

months of 2012, the CNB purchased a net worth of EUR 209.1m. The net foreign currency purchases were due to the fact that foreign currency purchases from the government exceeded the amounts sold to banks, with the result that the CNB created a total of HRK 1.6bn in reserve money. All this helped maintain favourable liquidity in the monetary system and low money market interest rates.

Following a slight slowdown in the first half of 2012, the kuna/euro exchange rate moved at slightly lower levels during the third quarter relative to the former part of the year. Apart from the domestic currency appreciation, typical of the summer months as a result of seasonal foreign currency inflows, the appreciation pressures were also driven by expectations of foreign borrowings by some public and private enterprises. The appreciation of the kuna against the US dollar and the Swiss franc in the third quarter reflects the movements of the euro against these two currencies in the global foreign exchange market. At end-September, the HRK/USD and HRK/CHF exchange rates thus held steady at end-2011 levels.

Gross international reserves rose by EUR 0.4bn in the first half of the year, but fell by EUR 0.2bn in the third quarter, standing at EUR 11.4bn at the end of September. In the first nine months of 2012, gross and net usable international reserves grew by 1.8% and 3.0% respectively. These increases were mostly driven by the CNB's net foreign exchange purchases in foreign exchange transactions with banks and the central government. The level of the reserves continued to exceed by a large margin the amount of both money (M1) and reserve money (M0) in Croatia at the end of the third quarter.

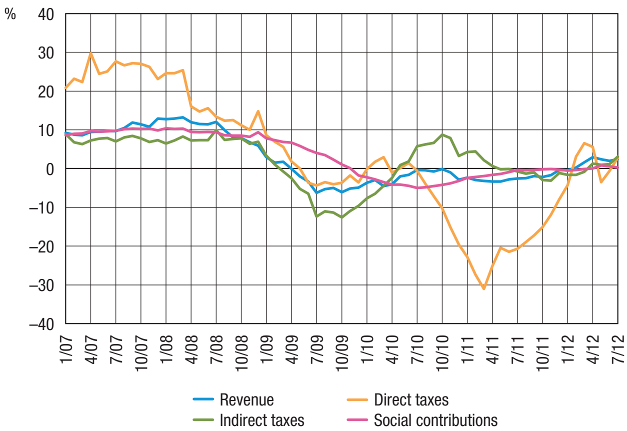
Developments in the real seasonally adjusted value of monetary aggregates reflect unfavourable trends in real activity, as well as a moderate pick-up in inflation. Thus, money and total liquid assets decreased in the first eight months of 2012, but stagnated relative to the end-2011 levels. Slightly more favourable developments were observed in nominal monetary aggregates in the third quarter, thanks to a marked increase in corporate and household deposits. Viewed from a longer-run perspective, M1 monetary aggregate was still much below its pre-crisis level, while the real seasonally adjusted value of M4 went up slightly.

9 Public finance

Despite less favourable economic trends and announcements of reduction in the tax burden made at the time the budget was adopted, tax law amendments and improved collection of taxes and contributions in the first seven months of 2012 led to an annual increase of 3.6% in consolidated central government revenues. The favourable dynamics of revenues in the January to July period may be largely attributed to a 2 percentage point increase in the basic VAT rate at the end of the first quarter of 2012. Only excise revenues made a strong negative contribution to revenues, largely due to the drop in revenues from excises on refined petroleum products, which reflected dwindling demand in response to rising prices of refined petroleum products. The estimated impact of tax law amendments in 2012 and developments in relevant macroeconomic variables cannot explain entirely the revenue dynamics in the period under review, for measures leading to improved revenue collection also had an effect. This is particularly noticeable in revenues from social contributions; notwithstanding the cut in the rate of health insurance contributions from 15% to 13% in early May, these revenues grew marginally, as the government stipulated that employers may not pay out employee wages without first paying contributions to the government.

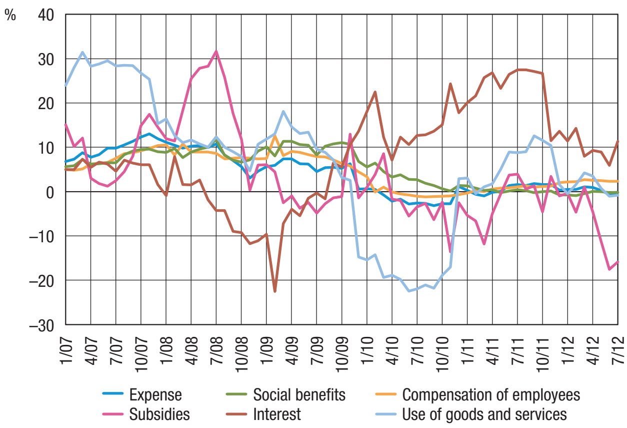
Consolidated central government expenditures edged up by 0.4% in the first seven months, although the budget envisaged their significant reduction. A considerable difference between the actual and planned expenditure dynamics for 2012 is evident in expenditures for employees and social benefits. Instead of falling sharply on an annual basis as planned, they grew slightly in the period under review. The increase in social benefits was largely due to the rise in health care expenditures, while expenditures for employees grew on account of a rise in the number of civil servants and government employees,

Figure 37 Consolidated central government revenue
year-on-year rate of change of twelve-month moving sums



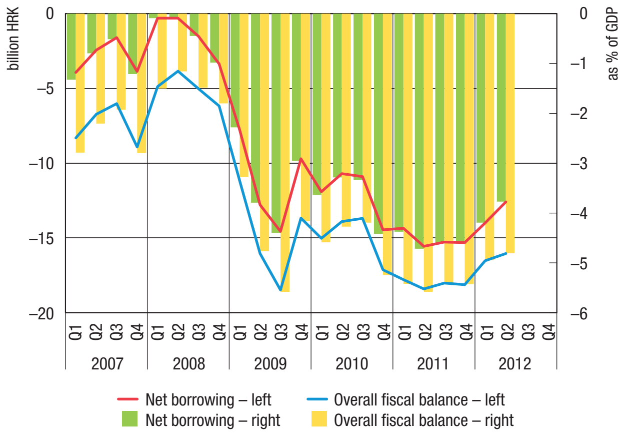
Note: From January 2008 on, CM is excluded from consolidated central government.
Source: MoF (CNB calculations).

Figure 38 Consolidated central government expense
year-on-year rate of change of twelve-month moving sums



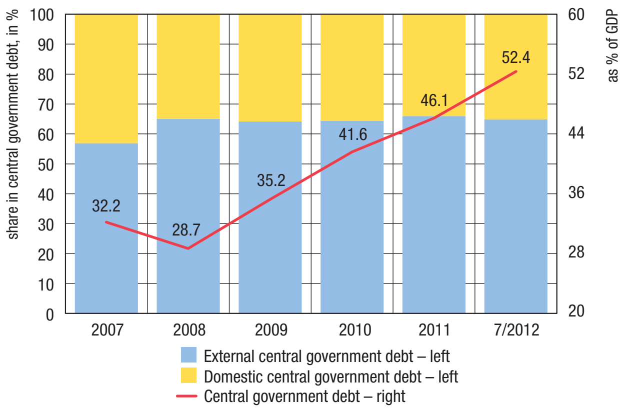
Note: From January 2008 on, CM is excluded from consolidated central government. Expense includes expenditures for the acquisition of non-financial assets.
Source: MoF (CNB calculations).

Figure 39 Consolidated central government balance
four-quarter moving sums



Source: MoF (CNB calculations).

Figure 40 Central government debt
end-period stock



Note: From January 2008 on, CM is excluded from consolidated central government. The sum of quarterly GDP values in the last four quarters has been used to calculate the ratio of central government debt to GDP at the end of July 2012.
Source: CNB.

as well as their average wages. Owing to the public debt increase in 2011, the largest positive contribution to expenditure trends came from interest expenses. All these increases were somewhat alleviated by the cuts in expenditures for subsidies, particularly those to farmers, as well as by savings in material expenses and other expenditures (above all, lower transfers to Croatian Railways).

The acquisition of non-financial assets was reduced noticeably, probably due to fiscal authorities' efforts to compensate for the unplanned increase in some current expenditures. Outlays for net loans granted increased, partly on account of larger payments arising from activated guarantees. Outlays for loans show that the government has already spent planned guarantee reserves.

The central government deficit was HRK 8.6bn in the first seven months of 2012, which is a decrease of HRK 1.7bn from the same period in the previous year. The deficit was financed by borrowing, given the absence of any significant receipts from privatisation or the disposal of non-financial assets.

Public debt growth picked up considerably due to the assumption of shipyards' liabilities. Public debt grew much more in the first seven months of 2012 than in the same period in 2011 (HRK 20.8bn vs HRK 15.3bn) as the government assumed some HRK 8.5bn of shipyards' credit liabilities as the public debt in the period under review. Hence, central government debt reached HRK 174.7bn (52.4% of GDP) at end-July 2012.

10 Business operations of credit institutions

In early 2012, the domestic banking sector was faced with prolonged recession, a fall in total economic activity and instabilities spilling over strongly from the eurozone to the domestic market. Despite central bank measures to alleviate these pressures, the negative impacts prevailed by end end-June, with the bank balance sheet contracting 1.0% in the first half of 2012 and the generated profit falling by a high 15.2% compared to the same period in the previous year, mainly as a result of rising borrowing costs on the foreign financial market. The banks managed to keep the share of net interest income in net income at the last ten year average level, at the same time maintaining satisfactory efficacy through tightened control of expenses. Value adjustments and loss provisions again absorbed almost one half of the profit. As a result ROAA fell from 1.2% to 1.1% and ROAE fell from 6.9% to 6.3% from the end of 2011.

Small balance sheet restructuring coupled with rising caution of banks had a negative impact on the level of total placements and assumed off-balance sheet liabilities, which fell by HRK 11.4bn or 2.6% in the first half of 2012. The total level of loans granted held steady, despite noticeable changes in their structure by sectors. The assumption by the government of government-guaranteed credit liabilities of shipyards and their transformation into public debt led to increased exposure of banks towards the government units sector. An increase in loans was seen only in the low-risk public enterprises sector, contrasting with the deleveraging seen in other corporates and households. The quality of placements, due to a fall in the base and portfolio ageing, continued to deteriorate, with the share of partly recoverable and fully irrecoverable loans in total loans reaching 13.3%. The expected losses on these loans kept growing steadily, at slightly higher rates, reversing the downward trend in the coverage of loans by value adjustments this year, which nevertheless failed to reach pre-crisis levels.

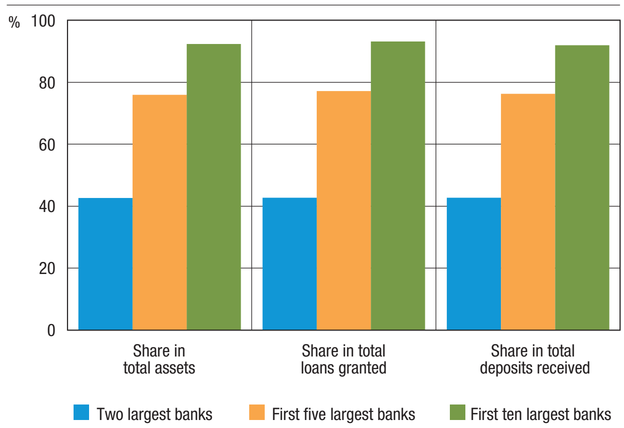
Increased system liquidity was partly used for bank deleveraging abroad, mainly by reducing the use of sources from majority foreign owners. Nevertheless, they still accounted for a significant 19.8% of the total sources of financing. As regards the domestic sources of financing, household deposits were again a stable source of bank financing, despite the fact that their growth slowed down considerably, to only 1.1%. Considerable growth rates were seen only in deposits of other banking and non-banking institutions. A strong contraction in corporate deposits of 14.1% was due to the absence of recovery in the real sector, moderate deleveraging as well as earlier dividend payments, spurred by a new tax burden. The banks continued to strengthen their capital base by retaining one half of the amount of the previous year's profit and smaller recapitalisations in several small banks. Total capital requirements fell at the same time, with the capital adequacy ratio reaching 20.17%, its highest value in the past twelve years.

10.1 Banks

10.1.1 Structural features

At the end of June 2012, there were 37 credit institutions operating in the Republic of Croatia: 31 banks, one savings bank and five housing savings banks. The number of credit institutions remained unchanged from the end of 2011. At the end of the first half of 2012, their assets stood at HRK 410.3bn, with the banks (the savings bank included) accounting for a dominant 98.2% and housing savings banks for the remaining 1.8% of total assets. The banks have been divided into three peer groups (large, medium-sized and small banks) fn [9], while housing savings banks, due to their specific nature,

Figure 41 Shares of assets, loans and deposits of the largest banks in total assets, loans and deposits
as at 30 June 2012



Source: CNB.

Table 1 Bank peer groups and their share in total bank assets
end of period

	Dec. 2009		Dec. 2010		Dec. 2011		Jun. 2012	
	Number of banks	Share	Number of banks	Share	Number of banks	Share	Number of banks	Share
Large banks	6	82.7	6	82.1	6	82.6	6	82.4
Medium-sized banks	3	9.1	3	9.0	3	9.0	3	9.2
Small banks	25	8.2	24	8.9	23	8.4	23	8.4
Total	34	100.0	33	100.0	32	100.0	32	100.0

Source: CNB.

9 Large banks are banks whose assets exceed 5% of the total assets of all banks, medium-sized banks are banks whose assets are greater than 1% and less than 5% of the total assets of all banks, and small banks are banks whose assets are less than 1% of the total assets of all banks.

Table 2 Ownership structure of banks and their share in total bank assets
end of period

	Dec. 2009		Dec. 2010		Dec. 2011		Jun. 2012	
	Number of banks	Share	Number of banks	Share	Number of banks	Share	Number of banks	Share
Domestic ownership	19	9.1	18	9.7	15	9.4	15	9.4
Domestic private ownership	17	4.9	16	5.4	13	4.9	13	4.9
Domestic state ownership	2	4.2	2	4.3	2	4.5	2	4.6
Foreign ownership	15	90.9	15	90.3	17	90.6	17	90.6
Total	34	100.0	33	100.0	32	100.0	32	100.0

Source: CNB.

are treated as a separate group.

At the end of June 2012, the total number of banks as well as the distribution of banks by peer groups held steady at the end of last year level (Table 1). The market shares of medium-sized and large banks underwent smaller changes attributable to an increase in the assets of medium-sized banks (1.1%) and a decrease in the assets of large banks (1.2%). The share of assets of the small banks group in total bank assets remained unchanged.

The developments in the concentration indicator at the end of the first half of 2012 compared to the end of 2011 were very small, with system concentration remaining high (Figure 41). The only visible increase in share was seen in the assets of the two largest banks which rose by 0.4 percentage points to 42.6%. The share of assets of the five largest banks in total assets of banks fell very slightly to 75.9%, while the share of assets of the ten largest banks rose slightly, to 92.4% of the total assets. Only a few smaller banks saw a small increase in credit activities in the first half of the year, which led to a fall in the indicators of concentration of the given net loans measured by the share of the two, five and ten largest banks, although these shares remained high.

The ownership structure of banks remained unchanged in the first six months of 2012. A total of 17 banks were in the majority ownership of foreign shareholders and 15 banks were in the majority ownership of domestic shareholders (Table 2). The changes in the share of bank assets by type of ownership were very small and amounted to less than 0.1 percentage point. The largest number of banks (six) were in the ownership of Austrian shareholders, and the assets of these banks accounted for a high 61.6% of the total assets of all banks. Five banks were in the ownership of Italian shareholders and their market share stood at 18.9%. Shareholders from France and Hungary accounted for almost 10% of total assets and each had one bank in their ownership, while the share of the remaining four banks, in the ownership of shareholders from San Marino, Turkey, Switzerland and Serbia, was very small.

10.1.2 Bank balance sheet and off-balance sheet items

Assets

The effects of the prolonged economic crisis were seen in a slowdown in the business activities of banks. After a small recovery in their growth rates in 2010 and 2011, in the first half of 2012 bank assets fell by HRK 3.9bn or 1.0% (Table 3). Loans granted held steady (–0.3%) and the fall in their amount was partly offset by the measures taken by the central bank to boost economic activity. These measures mobilised a significant amount of the hitherto immobilised funds and led to considerably lower regulatory costs. However, they had no significant impact on credit growth due to increased caution on the part of the banks and bank clients. As a result, some of the mobilised funds were used for the repayment of liabilities, particularly foreign loans. As in previous years, the contribution to slower assets growth came from value adjustments and loss provisions[10] the increase of which was due to further worsening of debtor positions and difficulties in the collection of receivables.

The amount of loans granted declined in large banks (–0.8%) but rose in medium-sized and small banks, by 3.3% and 1.1%, respectively. The reason for the fall in large bank loans lay primarily in a smaller amount of loans to government units, a significant part of which can be attributed to early repayment of a loan in one large bank. At the same time, the banks considerably increased their investments in this sector's securities, which was made possible owing to the CNB measures mentioned. Medium-sized banks increased loans to government units while small banks increased their loans to financial institutions.

The changes in the rule on the minimum foreign exchange liquidity enabled the inclusion of euro T-bills of the MoF subscribed at an auction on 14 February 2012 in liquid foreign currency claims[11]. As a result, the foreign currency claims to foreign currency liabilities ratio thus held steady at the same level as at the end of 2011 (19.3%). The subscription of the mentioned T-bills of EUR 758.8m was financed by deposit withdrawals from foreign banks. At the end of the first half of 2012, these deposits were down by almost HRK 5.0bn or 20.0% from the end of the previous year. The amount of deposits with the CNB also fell considerably, partly due to a smaller amount of reserve requirements set aside as a result of a reduction in the rate of reserve requirements allocation from 15% to 13.5% in May 2012.[12] The banks placed a part of the released reserve requirements to the CBRD (a syndicated 13-bank loan of HRK 3.4bn) in the context of the first phase of the Economic Development Programme aimed at ensuring favourable loans to domestic entrepreneurs, to be granted by the banks and the CBRD in similar ratios. The banks bid for a credit quota amount relating to a share of CBRD funded loans and add to the quota granted an equal amount of own funds which are then placed to users. By end-June, one auction

10 In accordance with the applicable regulations, bank assets are reported net, i.e. reduced by value adjustments and provisions.

11 Decision on amendments to the Decision on the minimum required amount of foreign currency claims (OG 18/2012). As the bulk of the subscribed T-bills had a maturity of 546 days, they were reported by banks under bonds.

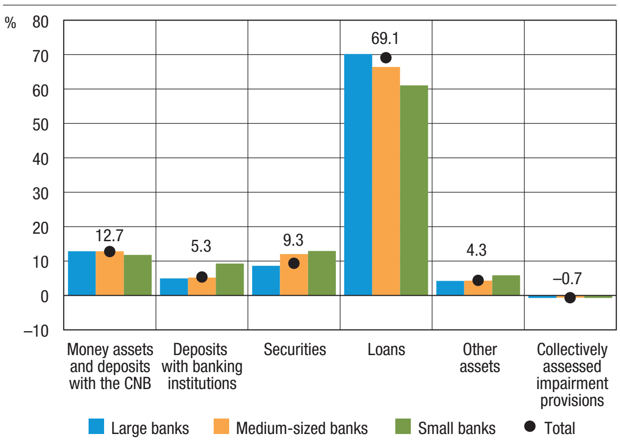
12 Decision on amendments to the Decision on reserve requirements (OG 43/2012).

Table 3 Structure of bank assets
end of period, in million HRK and %

	Dec. 2009		Dec. 2010			Dec. 2011			Jun. 2012		
	Amount	Share	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
Money assets and deposits with the CNB	47,673.1	12.6	47,373.5	12.1	–0.6	53,058.7	13.0	12.0	51,314.0	12.7	–3.3
Money assets	5,430.9	1.4	5,675.4	1.5	4.5	6,198.2	1.5	9.2	6,789.1	1.7	9.5
Deposits with the CNB	42,242.2	11.2	41,698.2	10.7	–1.3	46,860.5	11.5	12.4	44,525.0	11.0	–5.0
Deposits with banking institutions	32,741.9	8.7	30,160.0	7.7	–7.9	26,957.3	6.6	–10.6	21,436.1	5.3	–20.5
MoF treasury bills and CNB bills	9,366.8	2.5	10,030.3	2.6	7.1	11,580.0	2.8	15.5	11,708.4	2.9	1.1
Securities and other financial instruments held for trading	5,522.4	1.5	5,501.3	1.4	–0.4	2,511.5	0.6	–54.3	837.5	0.2	–66.7
Securities and other financial instruments available for sale	14,000.5	3.7	14,872.5	3.8	6.2	14,281.2	3.5	–4.0	18,163.6	4.5	27.2
Securities and other financial instruments held to maturity	4,012.2	1.1	3,692.3	0.9	–8.0	3,664.5	0.9	–0.8	4,064.8	1.0	10.9
Securities and other financial instruments not traded in active markets but carried at fair value	1,644.9	0.4	1,090.0	0.3	–33.7	1,829.5	0.4	67.8	2,627.7	0.7	43.6
Derivative financial assets	212.4	0.1	154.6	0.0	–27.2	673.9	0.2	335.9	1,042.1	0.3	54.6
Loans to financial institutions	6,065.1	1.6	6,389.5	1.6	5.3	6,162.3	1.5	–3.6	8,713.1	2.2	41.4
Loans to other clients	246,363.2	65.1	260,690.5	66.7	5.8	273,122.5	67.1	4.8	269,680.4	66.9	–1.3
Investments in subsidiaries and associates	1,980.9	0.5	2,195.6	0.6	10.8	3,288.7	0.8	49.8	3,292.9	0.8	0.1
Foreclosed and repossessed assets	604.9	0.2	757.5	0.2	25.2	868.4	0.2	14.6	1,080.1	0.3	24.4
Tangible assets (net of depreciation)	4,372.3	1.2	4,319.6	1.1	–1.2	4,417.7	1.1	2.3	4,390.1	1.1	–0.6
Interest, fees and other assets	6,889.5	1.8	6,853.3	1.8	–0.5	7,592.0	1.9	10.8	7,707.5	1.9	1.5
Net of: Collectively assessed impairment provisions	3,079.5	0.8	3,009.3	0.8	–2.3	3,070.6	0.8	2.0	3,014.8	0.7	–1.8
Total assets	378,370.6	100.0	391,071.2	100.0	3.4	406,937.6	100.0	4.1	403,043.4	100.0	–1.0

Source: CNB.

Figure 42 Structure of bank peer group assets
as at 30 June 2012



Source: CNB.

had been held at which the CBRD offered to the banks HRK 500.0m, while due to the short time available, no loans were granted to entrepreneurs until the end of that month. To boost the Programme's realisation, another change was introduced in the rule on the minimum foreign currency coverage[13]. This change enabled the inclusion of loans granted under the Programme, in particular that part of loans granted by banks in foreign currency claims, irrespective of the currency.

Because of the growth in T-bill investments and investments in the bonds of foreign financial institutions and the securities of domestic corporates, the total amount of securities investments rose by a considerable HRK 3.5bn or 10.4%. These investments accounted for 9.3% of bank assets (Figure 42), their highest share since end-2008. Bonds accounted for almost one half of the total securities investments and three quarters of these bonds were accounted for by domestic bonds and bonds of different foreign central governments, with bonds

13 Decision on amendments to the Decision on the minimum required amount of foreign currency claims (OG 67/2012).

of the Republic of Croatia accounting for a dominant share. Looking by portfolios, the amount of securities in the portfolio of financial assets available for sale rose the most, with the share of this portfolio exceeding two thirds of the total securities investments. Favourable developments in bond prices played a large role in reducing unrealised losses on the value adjustment of financial assets available for sale recorded in the capital accounts, which had a favourable impact on the level of bank capital. The amount of securities in the portfolio held for trading fell, thus continuing the downward trend present for a long time, and keeping the level of the portfolio of securities held for trading at a much lower level than in the pre-crisis period.

Assets taken over in exchange for unpaid receivables accounted for a little over HRK 1.0bn or 0.3% of the total assets of banks. The share of these assets was relatively low; however, its increase in the first half of 2012 of HRK 211.8m or 24.4% largely outpaced that in 2011. Both large and medium-sized banks saw a high growth rate of assets taken over, and yet the share of these assets in total assets was the highest in the group of small banks (1.4%). In addition to the assets taken over, of the remaining bank asset items, derivative financial assets also grew sharply, largely influenced by developments in one large bank.

Liabilities and capital

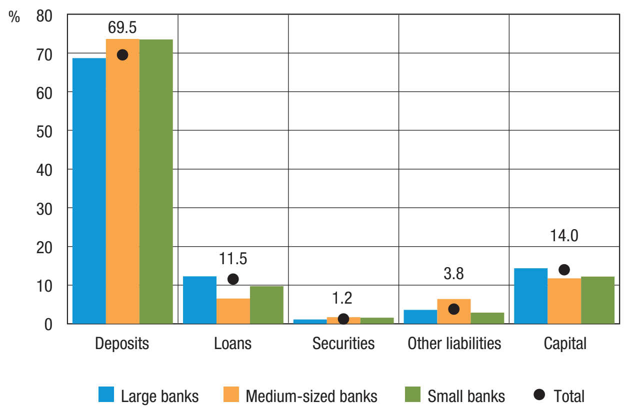
Weakened demand for loans and good system liquidity made it possible for the banks to reduce borrowing, particularly foreign borrowing. Bank liabilities fell by HRK 4.4bn or 1.3% in the first half of 2012 (Table 4), with the largest share of this amount being attributable to a decline in loans and deposits received from majority foreign owners. The domestic sources of financing also declined. This was particularly true of corporate deposits whose liquidity position evidently continued to weaken steadily.

The trend in which loans and deposits received from majority foreign owners had been both a stable and a significant source of domestic bank growth from the beginning of the crisis period came to a halt during the observed period. The sources from majority foreign owners declined by HRK 3.1bn or 4.5%, but again accounted for a little more than one fifth of the total sources of financing. Twelve banks used sources from majority foreign owners, in ranges that differed greatly among individual institutions and that in some banks led to a very high degree of the concentration of sources. The kuna component accounted for a little over one quarter of the sources from the majority foreign owners, due to regulatory arbitrage associated with the rule on minimum foreign currency liquidity which resulted in foreign exchange swap agreements with the parent banks. During the observed period, kuna sources from majority foreign owners fell by a slightly smaller amount than foreign currency (foreign currency-indexed included) sources from majority foreign owners, although the rate of their fall was faster, with their share in the total sources from majority foreign owners falling slightly.

In addition to loans from majority foreign owners, loans from other non-residents and domestic creditors, most notably domestic banks, also fell, with the total loans received falling by HRK 2.8bn or 5.7%. While present in all bank groups, this fall was slightly smaller in the group of small banks than in the remaining two bank groups. Down by HRK 1.2bn or 0.4%, the fall in received deposits was much smaller than the fall in received loans. Corporate deposits fell by a significant HRK 6.2bn or 14.1% which, despite an increase in the deposits of all the remaining domestic sectors, led to a fall in total deposits of the domestic sector. As in 2011, corporate deposits fell the most in small banks. The deposits of financial institutions rose sharply, by HRK 3.7bn or 26.5%, driven largely by growth in investment fund deposits, particularly money market funds. The growth in deposits of financial institutions was particularly fast in medium-sized banks, with the result that this bank group was the only group that reported an increase in total deposits. The deposits of financial institutions in large banks also rose sharply but they fell in small banks. Unlike institutional investors who, on account of the winding-up of one small bank towards the end of 2011, still exercised increased caution with respect to small banks, households increased their savings in small banks by 1.4%, or the highest rate among all bank groups. The stabilisation of operations enabled the repayment of liquidity funds taken from the CNB, with the result that, at the end of June 2012, no banks made use of the liquidity facility or the reserve requirements funds.

Household deposits rose by HRK 1.7bn or 1.1%, and with a share of almost 50% bolstered their leading position in the structure of the total sources of funds. From end-2008, the share of households strengthened considerably and so did the share of sources from majority foreign owners, while the sources from corporate and domestic financial institutions declined, reflecting the falling liquidity of the real sector and relatively slow activities in the capital and other financial markets. Household savings growth dynamics also waned. Foreign currency deposits were dominant in the structure of these savings and it was these deposits that rose the most in the first half of 2012. However, in relative terms, the kuna component rose more sharply. Household time kuna deposits rose by 6.2%, while those in euro remained at almost the same level. Deposits in other foreign currencies, particularly those in the American dollar, the Swiss franc and the Australian dollar rose sharply. Relatively strong, though small in terms of the amount, was the growth in deposits in otherwise very poorly represented currencies, such as for instance the Norwegian krone and the pound sterling. This was due developments in 2011 associated with heightened insecurity in the eurozone.

Figure 43 Structure of bank peer group liabilities and capital
as at 30 June 2012



Source: CNB.

Table 4 Structure of bank liabilities and capital

end of period, in million HRK and %

	Dec. 2009		Dec. 2010			Dec. 2011			Jun. 2012		
	Amount	Share	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
Loans from financial institutions	21,180.5	5.6	18,178.8	4.6	–14.2	17,316.5	4.3	–4.7	16,459.3	4.1	–4.9
Short-term loans	10,167.9	2.7	7,407.9	1.9	–27.1	6,026.7	1.5	–18.6	4,406.5	1.1	–26.9
Long-term loans	11,012.6	2.9	10,770.9	2.8	–2.2	11,289.8	2.8	4.8	12,052.8	3.0	6.8
Deposits	256,810.0	67.9	269,182.6	68.8	4.8	281,390.5	69.1	4.5	280,185.2	69.5	–0.4
Giro account and current account deposits	34,526.9	9.1	37,258.1	9.5	7.9	39,628.4	9.7	6.4	37,222.5	9.2	–6.1
Savings deposits	24,531.3	6.5	26,705.5	6.8	8.9	26,376.2	6.5	–1.2	25,992.3	6.4	–1.5
Time deposits	197,751.7	52.3	205,219.0	52.5	3.8	215,386.0	52.9	5.0	216,970.4	53.8	0.7
Other loans	31,787.5	8.4	31,594.3	8.1	–0.6	31,856.5	7.8	0.8	29,933.1	7.4	–6.0
Short-term loans	6,133.5	1.6	6,977.0	1.8	13.8	3,357.8	0.8	–51.9	2,980.1	0.7	–11.2
Long-term loans	25,654.0	6.8	24,617.3	6.3	–4.0	28,498.7	7.0	15.8	26,953.0	6.7	–5.4
Derivative financial liabilities and other financial liabilities held for trading	418.9	0.1	1,475.2	0.4	252.1	1,383.7	0.3	–6.2	1,542.7	0.4	11.5
Debt securities issued	119.3	0.0	124.3	0.0	4.2	0.0	0.0	–100.0	0.0	0.0	0.0
Short-term debt securities issued	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term debt securities issued	119.3	0.0	124.3	0.0	4.2	0.0	0.0	–100.0	0.0	0.0	0.0
Subordinated instruments issued	396.6	0.1	468.4	0.1	18.1	1,366.2	0.3	191.7	1,377.3	0.3	0.8
Hybrid instruments issued	3,016.4	0.8	3,431.2	0.9	13.7	3,601.1	0.9	5.0	3,504.4	0.9	–2.7
Interest, fees and other liabilities	12,067.3	3.2	12,288.2	3.1	1.8	14,283.6	3.5	16.2	13,782.4	3.4	–3.5
Total liabilities	325,796.6	86.1	336,743.0	86.1	3.4	351,198.2	86.3	4.3	346,784.5	86.0	–1.3
Share capital	28,781.8	7.6	29,468.2	7.5	2.4	33,805.6	8.3	14.7	34,044.1	8.4	0.7
Current year profit/loss	3,277.7	0.9	3,450.8	0.9	5.3	3,784.9	0.9	9.7	1,775.5	0.4	–53.1
Retained earnings/loss	7,764.9	2.1	8,927.9	2.3	15.0	13,705.2	3.4	53.5	15,910.1	3.9	16.1
Legal reserves	1,084.1	0.3	1,097.9	0.3	1.3	1,058.6	0.3	–3.6	1,078.9	0.3	1.9
Reserves provided for by the articles of association and other capital reserves	11,789.2	3.1	11,382.4	2.9	–3.5	3,739.5	0.9	–67.1	3,460.9	0.9	–7.5
Unrealised gains/losses on value adjustments of financial assets available for sale	–27.7	0.0	20.0	0.0	–	–291.8	0.0	–	–6.5	0.0	–97.8
Reserves arising from hedging transactions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Previous year profit/loss	–96.0	0.0	–19.0	0.0	–80.2	–62.6	0.0	229.3	–4.1	0.0	–93.5
Total capital	52,574.0	13.9	54,328.2	13.9	3.3	55,739.5	13.7	2.6	56,258.9	14.0	0.9
Total liabilities and capital	378,370.6	100.0	391,071.2	100.0	3.4	406,937.6	100.0	4.1	403,043.4	100.0	–1.0

Source: CNB.

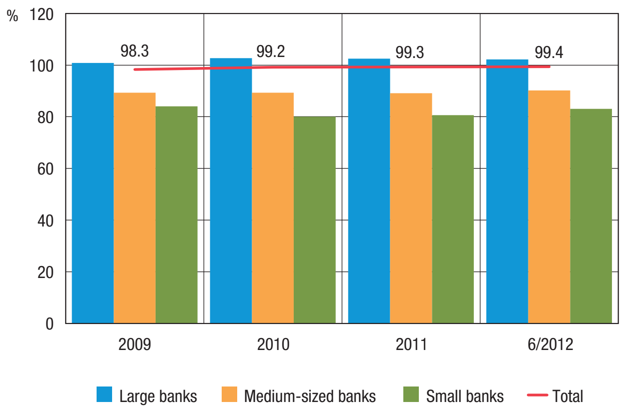
After a considerable growth in 2011, aimed in some banks at keeping the capital adequacy ratio at an appropriate level, the amount of subordinated and hybrid instruments fell slightly (1.7%) in the first half of 2012. This was due to the conversion of hybrid instruments into share capital in four banks, which provided an additional boost to capital and improved the quality of own funds.

Bank capital rose slightly, thus increasing its already high share in the liabilities of banks (Figure 43). Since the banks paid out one half of the profit generated in 2011 in the first half of 2012, the contribution to the increase in capital came from current year profit, recapitalisations of five small banks and considerably smaller unrealised losses on value adjustment of financial assets available for sale. Of the five small recapitalised banks, two were recapitalised exclusively by converting hybrid instruments in shares. On account of growth in share capital, capital rose the most in the group of small banks (6.6%). In this bank group, despite the burden created by current year and previous year losses, the capital to liabilities ratio was again satisfactory and stood at 12.2%. This ratio was the lowest in medium-sized banks (11.8%) and the highest in large banks (14.4%).

Liquidity indicators

The loans granted to deposits received ratio did not change much from the end of the previous year owing to their similar dynamics (Figure 44). This ratio fell only in large banks, although at 102.2% it was still the highest in this bank group. This ratio rose slightly in medium-sized banks and slightly faster (by almost 2.5 percentage points) in small banks, which nevertheless maintained the lowest loans granted to deposits received ratio (83.0%).

Figure 44 Bank loans granted/deposits received
end of period



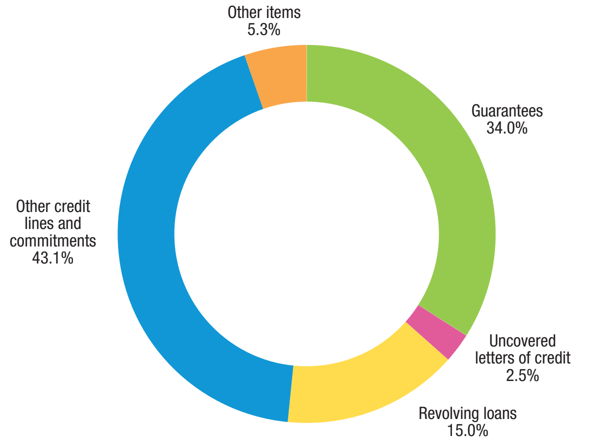
Source: CNB.

reduction in deposits in foreign banks and loans granted, particularly those in euro. Thus on the assets side, as in 2011, the share of kuna items continued to grow. On the liabilities side, this trend came to a halt as the share of kuna liabilities in total liabilities of banks fell. The fall in kuna liabilities was mainly due to a fall in the kuna loans received from both foreign and domestic banks as well as to a small fall in kuna deposits.

Standard off-balance sheet items

The downward trend in the amount of standard off-balance sheet items continued for the fourth consecutive year. At the end of the first half of 2012, standard off-balance sheet items stood at HRK 55.2bn (or 13.7% of bank assets), which is a decline of HRK 4.5bn or 7.5% from the end of the previous year. The bulk of the decline in the total amount of standard off-balance sheet items was due to a fall in their largest item, i.e. credit lines and other commitments, which declined by HRK 2.2bn or 8.5% from the end of 2011. Revolving loans also fell considerably (14.0%) and issued guarantees continued to trend downwards, falling by 3.6% from the end of 2011. Credit lines and other commitments again accounted for the largest share of total standard off-balance sheet items, although, on account of a large decline in the first half of this year, this share fell by half a percentage point (Figure 45).

Figure 45 Structure of bank standard off-balance sheet items
as at 30 June 2012



Source: CNB.

At the end of June 2012, the total minimum liquidity coefficient (MLC)[14] for a period up to one month, calculated for both kuna and convertible currencies combined, stood at 1.6. The mentioned 60% surplus liquidity as well as the percentage of coverage of foreign currency liabilities by liquid foreign currency claims of 19.3% compared to the minimum prescribed 17% bespoke high system liquidity. Only one small bank was faced with difficulties in maintaining the total MLC in the first half of 2012.

Currency adjustment of bank assets and liabilities

The banks protected a surplus of foreign currency assets over foreign currency liabilities (including assets and liabilities in kuna with a currency clause), i.e. a long spot foreign exchange position by means of forward agreements, thus reducing their direct exposure to currency risk. Due to the short position in euro, arising from a short forward position, the open net foreign exchange position of banks was short at the end of June 2012. It stood at HRK 788.8m or 1.4% of own funds and was much lower than the legally prescribed maximum of 30%.

In the first half of 2012, the kuna part of assets rose by 1.1% while the foreign currency part (items in kuna with a currency clause in foreign currencies included) fell by 2.1%. Given that the latter accounts for only slightly less than three quarters of the total assets, the total assets of banks also fell. Exchange rate changes were small and had no significant impact on the developments in the amount of foreign currency assets. While the increase in kuna assets can primarily be attributed to the realisation of a syndicated bank loan to CBRD, the fall in the amount in foreign currency assets was due to a considerable

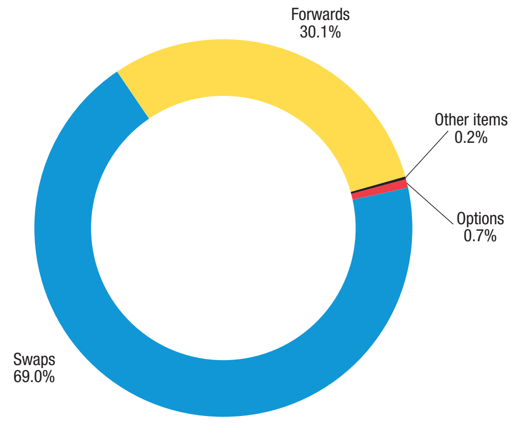
The group of small banks was the only bank group that increased the amount of standard off-balance sheet items in the first six months of 2012 (1.7%). In large and medium-sized banks these items fell by 8.3% and 1.9%, respectively. Even though small banks managed to increase somewhat the standard off-balance sheet items to assets ratio, this ratio again remained the lowest in this group (7.6%). At 14.8%, large banks again came first in terms of the level of this ratio while in medium-sized banks it stood at 9.6%.

Derivative financial instruments

The notional value of derivative financial instruments in the first half of 2012 rose by only HRK 0.3bn, resulting in an increase in the ratio of the notional value of derivative financial instruments and bank assets from 33.6% to 34.0%. Swaps again accounted for the largest share, or over two thirds of

14 Minimum liquidity coefficient (MLC) is calculated as the ratio of expected inflows (currently negotiable assets included) and the expected outflows under stress conditions in the last two given periods (up to one week and up to one month) and has to be equal to or greater than one. MLC is calculated for kuna, all convertible currencies combined and for each non-convertible currency individually, if significant. By way of exception, from 1 May to 31 December 2012, the banks were obligated to maintain MLC only on a collective basis, i.e. the MLC for kuna and for all convertible currencies combined. During this period, the banks were also allowed to maintain the MLC on a collective basis that was 10% lower than one (i.e. 0.9), for a period of maximum seven calendar days during a reporting month, irrespective of the fact whether the period concerned was a period up to one week or one month.

Figure 46 Structure of bank derivative financial instruments (notional amount)
as at 30 June 2012



Source: CNB.

derivative financial instruments, having increased their share in total derivative instruments by 1.3% to 69.0% (Figure 46).

This increase can fully be attributed to the increase in the notional amount of instruments with the exchange rate as the underlying variable (HRK 4.1bn or 10.2%). By contrast, instruments with interest rate as the underlying variable declined during the observed period by HRK 3.7bn or 13.4%. These changes led to changes in the structure of derivative financial instruments observed by type of the underlying variable and the largest group of instruments, that with the exchange rate as the underlying variable, increased its share in total instruments from 58.6% to 64.3%.

As at the end of 2011, large banks again had by far the highest derivative financial instruments to assets ratio (39.4%) (increasing by 0.2 percentage points). In medium-sized banks this ratio stood at 15.5% (increasing by 3.6 percentage points) and was again the lowest in small banks (1.5%). Large banks accounted for over 95% of the total notional value of derivative financial instruments.

As at the end of 2011, derivative financial instruments were almost fully intended for trading (over 99%). Although some of these instruments are used by banks to hedge against risks, they are not reported as such, probably due to the complex hedge accounting rules that such reporting would involve. Only around 1 per mille of the total of derivative financial instruments were reported as hedging instruments. Other derivative financial instrument involved embedded derivatives.

10.1.3 Earnings

Income statement

At the end of the first half of 2012, the banks generated HRK 2.1bn in profit (before tax), which is a decrease of HRK 382.4m or 15.2% from the end of the first half of 2011 (Table 5). The main reason for the fall in profit lay in higher costs of bank financing on the foreign financial market compared to the same period in the previous year, and this increase surpassed the increase in income and led to a fall in net income and profitability of banks. The additional negative impact on profit came from an increase in expenses on loss provisions and operating losses reported by almost one half of small banks at the end of the second quarter.

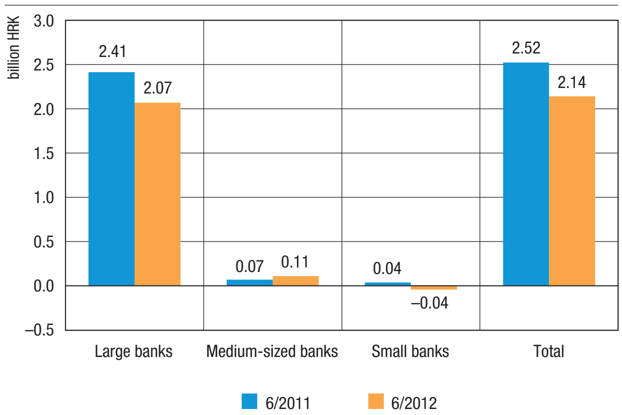
Compared to the same period in the previous year, only five banks, one large, two medium-sized and two small banks reported an increase in profit while another two banks that had operated with losses at the end of the first half of 2011 now reported a profit. The overall developments in bank income and expenses positions were influenced by changes in the group of large banks and a decline in this bank group profit of HRK 342.8m or 14.2% (Figure 47). A slow growth in interest income, coupled with a slightly faster growth in other non-interest income, could not offset the growing costs of borrowing of large banks based on deposits and loans received from foreign financial institutions, with the result that these changes led to a decline in their net income of 5.1%.

Compared to the first half of 2011, profit grew only in the group of medium-sized banks (55.3%). This was largely due to the profit reported by one bank in this group that was operating with a loss at the end of the same period of 2011 but also to the increase in profit of other banks in this group. Only medium-sized banks generated higher net income (3.5%), mainly attributable to higher other non-interest income from trading activities.

Due to losses of HRK 125.8m generated by 11 small banks, the performance of the group of small banks was negative. Compared to the same period in the previous year, the number of small banks that operated with a loss rose by two and the amount of loss involved was much bigger (83.1%). This was due to a fall in operating income, as well as to a significant increase of expenses on loss provisions (45.1%) which provided additional negative impact on the business performance. The assets of banks operating with a loss accounted for 2.3% of total bank assets and 27.2% of small banks' assets.

Up by HRK 832.5m or 17.3%, the increase in borrowing costs mentioned was the major factor that led to a fall in bank profits. The rising level of debt to foreign financial institutions compared to the same period of the previous year, coupled with the crisis deepening in the eurozone, fuelled banks' foreign financing costs, with the result that over one half of the total increase in interest expenses went to the costs of received deposits and loans of these institutions. Their growth rate was considerable (46.9%) and almost the entire increase was generated by large banks. The expenses on the sources from other

Figure 47 Bank income before taxes



Source: CNB.

Table 5 Bank income statement

in million HRK

	Large banks		Medium-sized banks		Small banks		Total	
	Jan.–Jun. 2011	Jan.–Jun. 2012	Jan.–Jun. 2011	Jan.–Jun. 2012	Jan.–Jun. 2011	Jan.–Jun. 2012	Jan.–Jun. 2011	Jan.–Jun. 2012
Net interest income	4,791.6	4,334.0	529.5	527.6	518.1	469.5	5,839.2	5,331.1
Total interest income	8,596.8	8,977.4	980.2	992.9	1,082.6	1,013.7	10,659.6	10,984.0
Total interest expenses	3,805.2	4,643.4	450.7	465.4	564.5	544.1	4,820.4	5,652.9
Net income from fees and commissions	1,197.8	1,162.6	158.4	160.6	106.1	99.9	1,462.4	1,423.1
Total income from fees and commissions	1,544.1	1,534.4	369.5	366.8	144.2	133.9	2,057.8	2,035.2
Total expenses on fees and commissions	346.3	371.9	211.1	206.2	38.0	34.0	595.4	612.1
Net other non-interest income	695.9	848.0	28.3	52.9	48.8	62.3	773.1	963.2
Other non-interest income	874.4	1,010.6	70.7	95.3	79.2	94.4	1,024.2	1,200.4
Other non-interest expenses	178.4	162.6	42.4	42.4	30.3	32.2	251.1	237.1
Net non-interest income	1,893.8	2,010.6	186.7	213.6	155.0	162.2	2,235.5	2,386.3
General administrative expenses and depreciation	2,862.4	2,844.3	455.6	461.6	530.8	522.0	3,848.8	3,827.9
Net operating income before loss provisions	3,823.0	3,500.3	260.6	279.6	142.3	109.7	4,225.8	3,889.6
Total expenses on loss provisions	1,410.0	1,430.0	189.1	168.6	103.6	150.3	1,702.7	1,748.9
Expenses on value adjustments and provisions for identified losses	1,316.5	1,501.6	191.4	171.8	105.1	151.1	1,613.0	1,824.5
Expenses on collectively assessed impairment provisions	93.5	–71.6	–2.2	–3.2	–1.5	–0.8	89.7	–75.6
Income/loss before taxes	2,413.0	2,070.2	71.5	111.0	38.6	–40.6	2,523.1	2,140.7
Income tax	386.1	342.9	12.3	6.8	18.8	15.5	417.3	365.2
Current year profit/loss	2,026.8	1,727.3	59.1	104.2	19.8	–56.1	2,105.8	1,775.5
Memo items:								
Gains (losses) from trading activities	–156.0	713.3	–72.0	48.0	50.3	46.5	–177.7	807.8
Gains (losses) from securities trading	–11.7	48.0	12.4	0.2	1.2	0.9	1.9	49.2
Gains (losses) from foreign currency trading	268.1	290.4	51.3	34.1	50.1	48.0	369.5	372.6
Gains (losses) from domestic currency trading	1.5	2.0	0.1	0.0	–0.3	–0.4	1.2	1.7
Gains (losses) from derivatives trading	–413.9	372.9	–135.8	13.6	–0.6	–2.1	–550.3	384.4
Gains (losses) from exchange rate differentials	546.6	–90.0	128.5	3.6	0.2	7.0	675.2	–79.4
Number of banks operating with losses	0	0	1	0	8	11	9	11

Source: CNB.

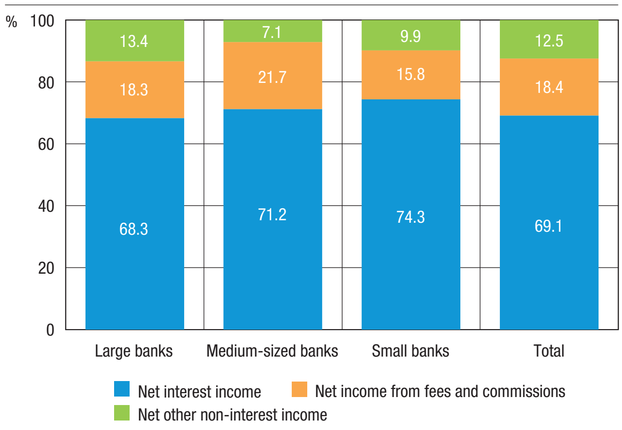
institutional sectors, except household deposits, for which the banks allocated a 1.9% lower amount of expenses, also rose to some extent. Considerably higher expenses on hybrid and subordinated instruments financing, which rose by almost 37.0%, also spurred an increase in interest expenses.

Unlike the considerable increase in interest expenses, total interest income rose only slightly (HRK 324.4m or 3.0%), reflecting developments in the structure and quality of bank placements. The absence of credit growth, coupled with an increase in the share of irrecoverable loans in total loans, led to a small decrease in interest income from loans, the key source of bank income, of 0.4%. The small growth in total interest income was thus due to higher income from banks' securities investments of HRK 145.0m or 20.5%. Since this income usually accounts for only a smaller share of the total interest income, their increase notwithstanding, the share of this income in interest income at the end of the first half of 2012 stood at below 8.0%. A considerable increase in interest income from debt securities was mainly due to income from domestic government securities, partly attributable to the restructuring of bank placements in the first half of 2012, when regulatory changes enabled substitution of deposits made by investments in the securities of the Republic of Croatia. These changes led at the same time to a considerable fall in interest income from deposits made (31.5%) which also negatively influenced, though to a lesser extent, the total level of interest income.

The fall in interest income from household loans of HRK 245.4m or 4.9% had a key impact on the fall in interest income from loans. Car purchase loans and other general-purpose loans accounted for the bulk of this fall. Income from home loans, the fall of which on an annual level had first been recorded at the end of the first quarter, also continued to decline. The banks reported a very small increase in interest income from corporate loans (0.3%), associated only with an increase in this income from loans to public enterprises, while income from loans to other corporates fell slightly (0.5%).

The fall in net income from fees and commissions of HRK 39.2m or 2.7% as a result of a smaller income and growing expenses on fees and commissions also had a negative impact on bank profit. The banks generated a smaller amount of income from fees for other banking services[15] while the increased expenses were associated with a higher amount of fees and

Figure 48 Structure of bank net income
as at 30 June 2012



Source: CNB.

commissions for non-resident services. The banks again generated the bulk or almost 45% of income from fees and commissions from payment services, this type of income continuing to grow slightly (0.7%).

Unlike unfavourable developments in net interest income and net income from fees and commissions, net other non-interest income of banks rose by a considerable HRK 190.1m or 24.6%, mainly as a result of an increase in other non-interest income and to a lesser extent to a reduction in these expenses[16]. Other non-interest income rose by 17.2%, mostly due to profit generated by large banks' derivative financial instruments trading and by small and medium-sized banks' foreign exchange trading. Currency risk hedging by means of derivative instruments was again effective, with profit generated by financial derivatives trading fully offsetting the loss arising from exchange rate differences and partly some of the increased interest expenses.

All this led to a decline in net income of banks of 4.4% from the same period in the previous year and to the diminished importance of net interest income in the structure of net income (Figure 48). Banks' reliance on less stable sources of income in the first half of 2012 led to an increase in the share of this income in net income. This was particularly true of the share of net other non-interest income, which rose by 2.9 percentage points to 12.5% of net income. Despite a bigger fall in the share of net interest income compared to the same period in the previous year (3.2 percentage points), 69.1% at the end of 2012, this share did not depart much from the previous ten-year average value of 69.7% of net income.

General administrative expenses and depreciation fell slightly (0.6%), influenced by a decline in depreciation expenses. Although kept under control, the fall in these expenses did not do much in the way of mitigating the fall in net income, with operating profit of banks (net operating income before loss provisions) falling by almost 8.0%.

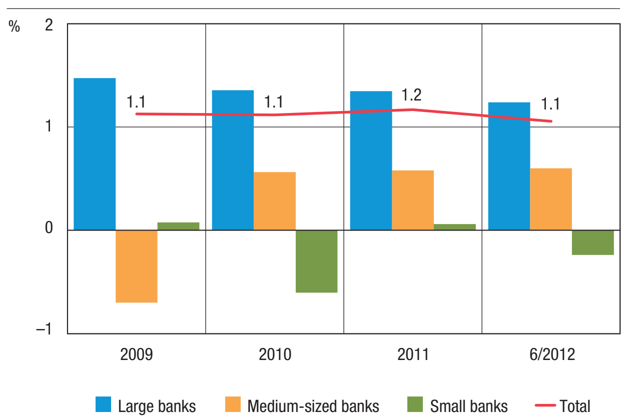
Further negative impact on bank profit compared with the same period in 2011 came from an increase in total expenses on loss provisions of HRK 46.2m or 2.7%. Although the increase in expenses on provisions for identified losses was much bigger (HRK 211.5m or 13.1%) than the total increase in expenses on loss provisions, the total change was largely offset by the abolition of expenses for latent losses on risk category A placements. As the base for the allocation of these provisions, i.e. provisions for risk category A placements, continued to fall steadily, the banks generated HRK 75.6m in income because of the abolition of these provisions, in contrast with the same period in the previous year, when they had reported HRK 89.7m in expenses on this basis. Changes in large banks played a key role in these developments, with their total provisioning expenses rising by only 1.4%, and the share of expenses that relates to identified losses by only 14.1%. Expenses on provisions for identified losses increased considerably in the group of small banks (43.7%), exceeding the amount of net income and resulting in an operating loss. Medium-sized banks reduced their total expenses on loss provisions by 10.9%, largely influenced by a fall in the provisions for identified losses in one medium-sized bank.

Indicators of returns

The fall in net operating income, coupled with the negative contribution that came from increased expenses on loss provisions, led to a fall in both indicators of return at the level of all the banks relative to the end of the same period 2011. The return on average assets thus fell to 1.1% while the return on average equity fell to 6.3% (Figures 49 and 50). Only medium-sized banks saw an increase in the value of the indicators of profitability. In this bank group, the return on average assets stood at 0.6% and the return on average equity at 4.9%. The values of these indicators fell in large banks and stood at 1.2% and 7.2%, respectively, while due to losses in small banks, the indicators of profitability were negative in these banks.

Taking into account the recommended values of these two indicators, at the end of the first half of 2012 only one large

Figure 49 Bank return on average assets (ROAA)
end of period

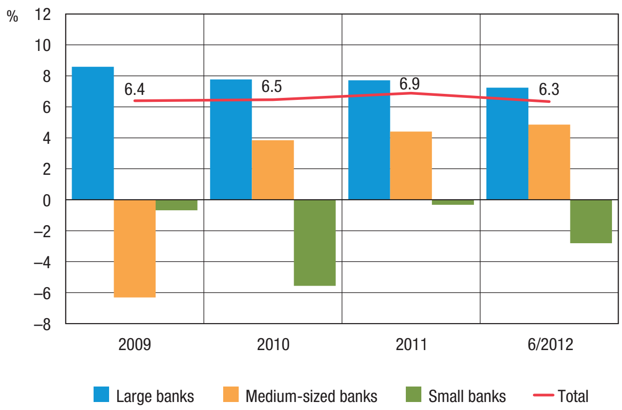


Source: CNB.

15 Fees for: issuing guarantees or other commitments, mandated operations, safekeeping securities and security transactions in the name and for the account of other persons, safe custody services, keeping of deposit accounts, services of issuing and managing unused credit lines, consultancy and advisory services to clients, issuing and using bank credit cards, collecting credit card receivables from buyers when the bank does not keep these receivables in its books, and other services.

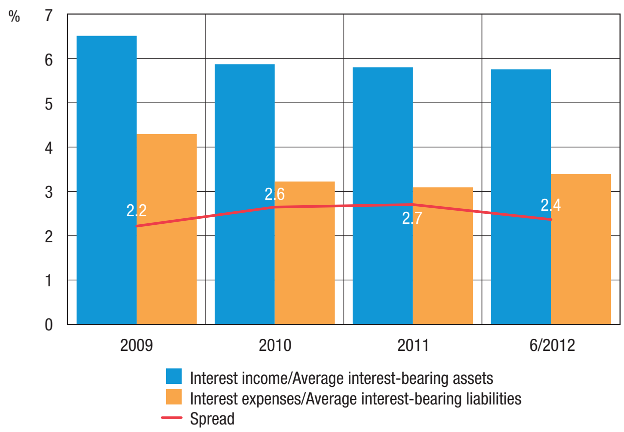
16 Entertainment and advertisement expenses, expenses on provisions for court proceedings against the banks, provisions for pensions and other liabilities towards the employees and expenses on provisions for taxes and contributions, etc.

Figure 50 Bank return on average equity (ROAE)
end of period



Source: CNB.

Figure 51 Income from interest-bearing assets and expenses on interest-bearing liabilities
end of period



Source: CNB.

bank had ROAA and ROAE values above 1% and 10%, respectively. Another five banks (three large and two small banks) had ROAA above 1%.

An increase in interest expenses bigger than in interest income led to a fall in the interest rate spread, i.e. the difference between interest income on average interest-bearing assets and interest expenses on average interest-bearing liabilities, from 2.8% at the end of the first half of 2011 to 2.4% at the end of the observed period (Figure 51). The growing costs of foreign financing had the biggest impact on the interest spread in large banks, which was down from 2.8% to 2.3%, a value below this indicator's value in other bank groups and all banks combined. Unlike large banks which managed to keep the same level of interest rate income on average interest-bearing assets, the fall in interest rate spread in medium-sized and small banks to 2.7% was actually the result of smaller interest income on average interest-bearing assets.

At the end of 2011, the average amount of assets per employee at the level of all banks stood at HRK 18.6m, but, following a decline in the total assets of banks at the end of the first half of 2012, this amount fell to HRK 18.5m. Although all bank groups reported a fall in assets per employee, it was the group of large banks that had a predominant influence on this change. As this bank group also saw a fall in the number of employees of 0.4%, the value of this indicator in large banks fell to HRK 20.9m. The amount of assets per employee was much lower in medium-sized (HRK 14.4m) than in large banks and was particularly lower in small banks (HRK 9.9m).

Following the trend of improvement in the cost to income ratio present for several years, the value of this indicator rose at the end of the first half of 2012, with the banks using 49.6% of net profit for the coverage of operating expenses (general administrative expenses and depreciation), an increase of 1.9 percentage points from the end of the first half of 2011. This was due to a fall in net income of large and small banks as a result of which the value of this indicator in small and large banks rose to 82.6% and 44.8%, respectively. By contrast, the cost to income ratio improved, i.e. the value of the operating expenses to net income ratio declined to 62.3% in medium-sized banks.

The increase in expenses on loss provisions coupled with a fall in operating income of banks led to an increase in their ratio from 44.4% at the end of 2011 to 45.0% at the end of the first half of 2012. Large banks used the smallest share of their operating income for the coverage of expenses on loss provisions (40.9%) and were followed by medium-sized banks, which used 60.3% of their operating income for this purpose. Due to the worsening of the credit portfolio quality of small banks, the expenses on loss provisions rose considerably in this bank group, exceeding the amount of operating income by HRK 40.6m.

10.1.4 Credit risk

Placements and assumed off-balance sheet liabilities

Total placements and assumed off-balance sheet liabilities that are exposed to credit risk[17] and are subject to classification into risk categories in accordance with the rules that govern classification, stood at HRK 426.3bn at the end of June 2012, which is a decline of HRK 11.4bn or 2.6% compared to the end of 2011. The fall in placements was largely due to balance sheet items restructuring, driven by two regulatory changes, while the effect of the small drop in loans on this fall was negligible.

Of all placements and assumed liabilities, deposits fell the most (HRK 7.8 bn or 10.6%). After the changes in the provision on the minimum required foreign currency claims in early 2012 had facilitated bank lending to the government, the banks subscribed EUR 758.8m worth of T-bills. The banks distributed these securities mainly in the portfolios of financial assets not exposed to credit risk which are not subject to classification into risk categories[18]. Some of the funds released on the basis of changes in the reserve requirements were used until end-June for lending to the CBRD (HRK 3.4bn) in the context of

17 Total bank exposure to credit risk comprises placements (balance sheet items) and assumed off-balance sheet liabilities. The placements can be divided into a loan and receivables portfolio and a portfolio of held-to-maturity financial assets, with the receivables on interest and fees being covered by a separate item (receivables based on income). The portfolio of financial assets comprises various instruments such as loans, deposits, bonds, and T-bills while assumed off-balance sheet liabilities comprise guarantees, credit lines, etc.

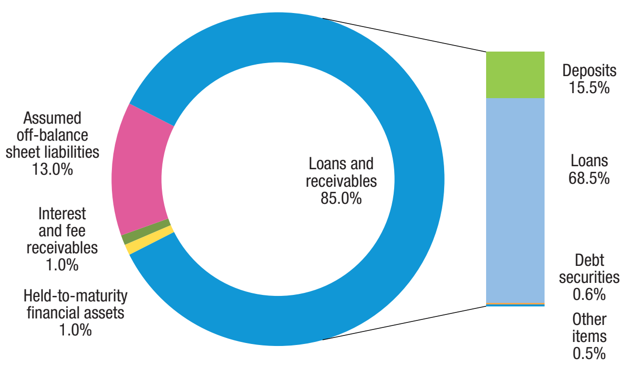
18 Approximately three quarters of the long-term issue was distributed in the portfolio of financial assets available for sale, while the remaining share was distributed in the portfolio of financial assets carried at fair value.

Table 6 Classification of bank placements and assumed off-balance sheet liabilities by risk categories
end of period, in million HRK and %

Risk category	Dec. 2009			Dec. 2010			Dec. 2011			Jun. 2012		
	Placements and assumed off-balance sheet liabilities	Value adjust-ments and provisions	Coverage (%)	Placements and assumed off-balance sheet liabilities	Value adjust-ments and provisions	Coverage (%)	Placements and assumed off-balance sheet liabilities	Value adjust-ments and provisions	Coverage (%)	Placements and assumed off-balance sheet liabilities	Value adjust-ments and provisions	Coverage (%)
A	403,906.5	3,613.0	0.9	386,077.1	3,564.9	0.9	398,369.0	3,600.3	0.9	384,541.6	3,523.4	0.9
B-1	10,764.0	1,416.9	13.2	16,233.9	2,151.0	13.2	16,731.9	2,341.9	14.0	17,413.4	2,450.3	14.1
B-2	5,303.4	2,225.6	42.0	9,327.2	4,147.6	44.5	13,909.9	6,173.1	44.4	14,678.0	6,695.6	45.6
B-3	1,283.3	931.8	72.6	1,895.2	1,518.0	80.1	1,854.0	1,486.9	80.2	2,257.5	1,802.5	79.8
C	5,366.6	5,281.8	98.4	5,784.8	5,784.4	100.0	6,852.2	6,852.2	100.0	7,422.4	7,421.8	100.0
Total	426,623.8	13,469.1	3.2	419,318.1	17,165.8	4.1	437,716.9	20,454.4	4.7	426,313.0	21,893.6	5.1

Note: Since 2010, the portfolio of financial assets available for sale has been excluded from the scope of placements and assumed off-balance sheet liabilities classified into risk categories.
Source: CNB.

Figure 52 Structure of bank placements and assumed off-balance sheet liabilities
as at 30 June 2012



Source: CNB.

the Economic Development Programme.

The assumed off-balance sheet liabilities also fell considerably (HRK 4.5bn or 7.5%). Off-balance sheet liabilities kept falling steadily throughout the past year, but they recorded their biggest fall in the first quarter of this year due to a fall in almost all items, particularly credit lines and revolving loans and to a lesser extent issued guarantees. This was the result of negative changes in the majority of large banks and in all the reported sectors, and particularly involved liabilities issued on behalf of corporates (both public and private) and the government

Large banks made the biggest contribution to the fall in exposure to credit risk, having decreased their deposits by a considerable 10.4% and assumed off-balance sheet liabilities by 8.3%. A small fall in total loans of 0.5% additionally fuelled the rate of fall in placements and assumed liabilities of this group to 3.1%. By contrast, a small growth in credit activity in the remaining two bank groups mitigated the effect of the fall in deposits made, with the result that the small banks maintained almost the same level of total placements and assumed liabilities, while the fall in exposure to credit risk in medium-sized banks stood at only 0.4%.

Influenced by a sharper fall in deposits and assumed off-balance sheet liabilities, which usually outdo loans granted in terms of quality, the share of risk category A in total placements and assumed off-balance sheet liabilities fell from 91.0% in 2011 to 90.2%. This was in line with the downward trend in the quality of the portfolio exposed to credit risk, present for the fifth consecutive year. The fall in the quality of placements in the first half of 2012 was fuelled additionally by the absence of any significant credit activity, with the share of partly recoverable placements and assumed off-balance sheet liabilities (risk categories B-1, B-2 and B-3) and fully irrecoverable placements and assumed off-balance sheet liabillities (risk category C) rising to 9.8%. The share of B[19] and C risk category placements and assumed off-balance sheet liabilities of banks in total placements and off-balance sheet liabilities grew steadily in each reporting quarter from June 2008, the last period before the crisis, when it stood at 3.3% and had tripled by end-June 2012.

The growth in the share of B and C category placements and assumed off-balance sheet liabilities, combined with growing losses on this portfolio, led to a ratio of total value adjustments and provisions to total placements and assumed off-balance sheet liabilities of 5.1% at the end of June. From the end of 2010, the rate of increase in value adjustments and provisions for B and C category was slightly faster than the increase in their base, thus leading to a steady increase in the coverage of these risk categories which rose from 42.8% in 2011 to 44.0%. Although the trend of fall in the coverage came to a halt and was reversed at that time, the growth rates were still very slow and the level of coverage recorded before the crisis has not yet been recovered. The increase in coverage in the first half of 2012 was very much due to a fall in the share of deposits and off-balance sheet liabilities, stagnation in loans and portfolio ageing. This last item was driven to an extent by a slightly faster increase in the risk category with low degrees of

19 The sum total of placements and assumed off-balance sheet liabilities classified into risk categories B-1, B-2 and B-3.

placement recoverability (below 30%), i.e. an increase in risk subgroups B-3 and risk category C[20]. Value adjustments and collectively assessed impairment provisions fell only slightly; however, on account of a sharper fall in the base, the coverage of A category remained at its usual level of 0.9%.[21]

All bank groups saw an increase in B and C category placements and off-balance sheet liabilities, with their highest growth rate being seen in the group of small banks in which the share of these placements in total placements and off-balance sheet liabilities rose to 13.6%, much above total bank average. To a great extent this was influenced by the structure of their placements, and especially by a much larger share of corporate loans in total loans compared to the other two bank groups. The share of B and C category placements and off-balance sheet liabilities of medium-sized banks stood at 13.0%, with above-average quality of placements (9.1%) being recorded only in the group of large banks.

Until end-June, due but unpaid receivables grew by HRK 4.6bn or 16.7%, a growth almost equal to that seen in the previous year on an annual level. The distribution of this amount by risk categories indicates that almost one half of the increase was explained by an increase in due category A placements, largely those with a maturity of up to 90 days, i.e. the increase in due loan receivables associated with working capital financing, investments and construction. The bulk of all semi-annual nominal changes can be attributed to large banks, although due but unpaid receivables rose the most in relative terms in the group of small banks (19.6%)

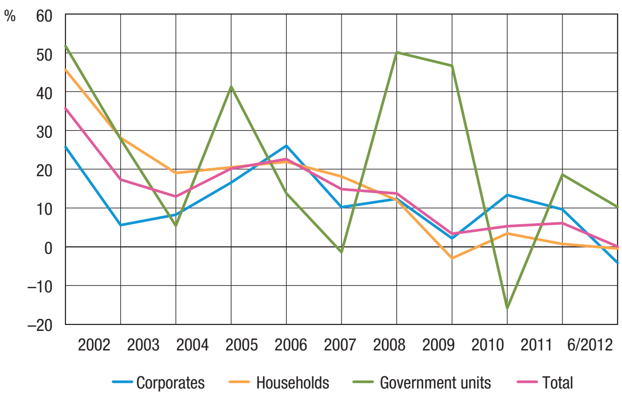
In the first six months of 2012, the dynamics of placement rollover and restructuring[22] held steady at the same level as in the same period in the previous year. This was largely due to large banks, particularly at the beginning of the year, which increased their placement rollover and restructuring activities vis-à-vis public enterprises.

Loans

Risk aversion on the domestic market was seen in the very small changes in loans on a semi-annual level. A small growth in credit activity observed in the first quarter of the year did not continue into the second quarter, with the result that at the end of June 2012, loans fell by a little less than 0.1% compared to the year before. The exchange rate effects excluded, loans fell only slightly faster, given the relatively small changes in the exchange rate of the kuna in the first half of the year, particularly in the exchange rate of the kuna against the euro.

The amount of loans in the first half of the year was determined by the realisation of the mentioned bank loan to the CBRD in the context of the Economic Development Programme. The effects of this Programme and exchange rate effects excluded, total loans fell by approximately 1.0%. Credit exposure of banks was also strongly influenced by sectoral changes that took place after the Ministry of Finance took over a little more than HRK 6bn in loans granted to shipyards. The

Figure 53 Rates of change of bank loans



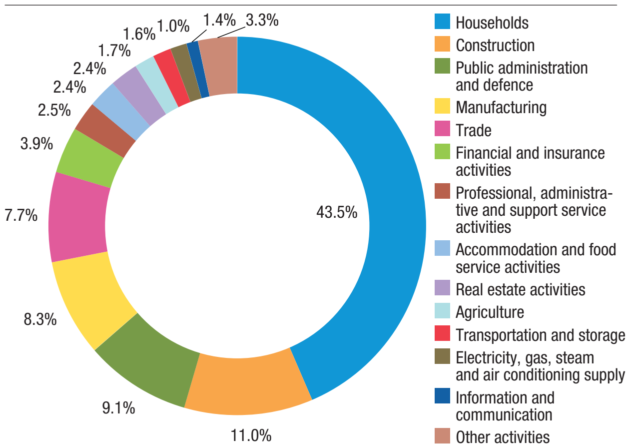
Note: From 2010, loans comprise loans classified into loans and receivables portfolio, distribution by sectors is carried out in accordance with ESA 95 and loans to non-profit institutions serving households are included in household loans.
Source: CNB.

effect of these sectoral changes excluded, loans fell as a result of a decline in borrowing in almost all sectors, particularly in government units. In the domestic sector, only public enterprises reported an increase in loans.

The trend of household deleveraging continued, although at a slower rate, for the fourth consecutive year, again mainly driven by a fall in car purchase loans. The reduction in the rate of reserve requirements in June 2012 reduced bank needs for loans, with the financial institutions sector, CBRD excluded, recording a fall in loans of 12.8%. Loans to non-residents, due to their low base, grew by a high 9.4% as a result of growth in all bank groups, particularly large banks.

The absence of recovery in credit activity and further unfavourable economic developments led to a further worsening in loan quality indicators, particularly in the corporate sector. The share of B and C category loans in total loans rose from 12.4% at the end of 2011 to 13.3% at the end of June 2012, while the share of these loans in the corporate sector rose from 20.1% to 22.8%. Though smaller in intensity, loan quality deterioration was also present in the household sector, affecting

Figure 54 Structure of bank loans by activities
as at 30 June 2012



Source: CNB.

20 Since March 2010, placements classified into risk category C have been shown on balance sheet accounts until completion of legal actions associated with the termination of the obligation of the debtor.

21 Credit institutions have to maintain the level of impairment (value adjustment) for placements and provisions for off-balance sheet liabilities classified into risk category A in the amount that is not below 0.85% or above 1.20% of the total balance of risk category A placements and off-balance sheet liabilities.

22 Placement restructuring caused by financial difficulties of the debtor requires reclassification into worse risk categories.

Table 7 Bank loans

end of period, in million HRK and %

	Dec. 2009		Dec. 2010			Dec. 2011			Jun. 2012		
	Amount	Share	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
Loans											
Government units	31,547.7	12.1	26,559.3	9.7	–15.8	31,496.8	10.8	18.6	34,725.1	11.9	10.2
Corporates	98,924.4	37.9	112,139.4	40.8	13.4	122,942.8	42.1	9.6	117,857.2	40.4	–4.1
Households	122,195.0	46.8	127,139.1	46.2	4.0	128,057.8	43.9	0.7	127,511.3	43.7	–0.4
Home loans	52,959.6	20.3	57,981.0	21.1	9.5	59,642.3	20.4	2.9	59,553.0	20.4	–0.1
Mortgage loans	3,084.2	1.2	3,513.3	1.3	13.9	3,261.3	1.1	–7.2	3,171.1	1.1	–2.8
Car loans	7,810.5	3.0	6,236.8	2.3	–20.1	4,539.4	1.6	–27.2	3,833.7	1.3	–15.5
Credit card loans	5,022.3	1.9	4,386.8	1.6	–12.7	4,109.3	1.4	–6.3	3,995.8	1.4	–2.8
Other household loans	53,318.4	20.4	55,021.2	20.0	3.2	56,505.5	19.4	2.7	56,957.7	19.5	0.8
Other sectors	8,472.0	3.2	9,111.8	3.3	7.6	9,219.5	3.2	1.2	11,803.3	4.0	28.0
Total	261,139.0	100.0	274,949.6	100.0	5.3	291,716.9	100.0	6.1	291,896.9	100.0	0.1
Partly recoverable and fully irrecoverable loans											
Government units	62.1	0.3	75.5	0.2	21.7	97.4	0.3	29.0	66.4	0.2	–31.8
Corporates	12,736.0	62.6	20,257.0	65.6	59.1	24,744.7	68.2	22.2	26,840.1	69.1	8.5
Households	7,081.3	34.8	9,930.1	32.2	40.2	11,020.9	30.4	11.0	11,352.9	29.2	3.0
Home loans	1,446.6	7.1	2,584.7	8.4	78.7	3,111.4	8.6	20.4	3,281.8	8.4	5.5
Mortgage loans	368.0	1.8	788.6	2.6	114.3	699.8	1.9	–11.3	700.0	1.8	0.0
Car loans	330.3	1.6	257.6	0.8	–22.0	181.5	0.5	–29.5	167.1	0.4	–7.9
Credit card loans	152.6	0.7	174.6	0.6	14.4	164.3	0.5	–5.9	172.3	0.4	4.9
Other household loans	4,783.8	23.5	6,124.6	19.8	28.0	6,863.9	18.9	12.1	7,031.7	18.1	2.4
Other sectors	481.7	2.4	616.1	2.0	27.9	411.5	1.1	–33.2	604.6	1.6	46.9
Total	20,361.1	100.0	30,878.6	100.0	51.7	36,274.5	100.0	17.5	38,864.1	100.0	7.1
Value adjustments of partly recoverable and fully irrecoverable loans											
Government units	5.5	0.1	6.0	0.1	8.8	19.8	0.1	228.2	25.6	0.2	29.4
Corporates	4,232.1	48.6	6,481.5	54.1	53.1	8,687.7	57.8	34.0	9,606.0	58.7	10.6
Households	4,309.5	49.5	5,269.9	44.0	22.3	6,059.2	40.3	15.0	6,426.7	39.3	6.1
Home loans	516.7	5.9	749.8	6.3	45.1	1,040.3	6.9	38.7	1,137.9	7.0	9.4
Mortgage loans	116.6	1.3	226.9	1.9	94.5	185.1	1.2	–18.4	206.7	1.3	11.7
Car loans	206.4	2.4	141.5	1.2	–31.4	138.9	0.9	–1.9	133.7	0.8	–3.7
Credit card loans	125.6	1.4	149.9	1.3	19.4	147.9	1.0	–1.3	155.5	1.0	5.1
Other household loans	3,344.2	38.4	4,001.7	33.4	19.7	4,547.0	30.3	13.6	4,792.9	29.3	5.4
Other sectors	163.5	1.9	230.0	1.9	40.7	262.6	1.7	14.2	307.0	1.9	16.9
Total	8,710.6	100.0	11,987.3	100.0	37.6	15,029.2	100.0	25.4	16,365.2	100.0	8.9

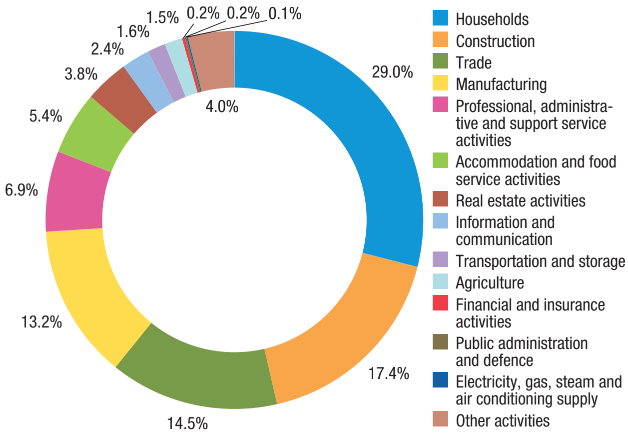
Note: From 2010, loans comprise loans classified into loans and receivables portfolio, distribution by sectors is carried out in accordance with ESA 95 and loans to non-profit institutions serving households are included in household loans.
Source: CNB.

all types of loans, particularly mortgage loans, with the result that the share of B and C category loans in total loans rose from 8.6% to 8.9% of total household loans.

At the end of June 2012, 35.8% of total B and C category corporate loans were covered by value adjustments, while the aggregate indicator (for total B and C category loans) was boosted by their considerably higher coverage in the household sector (56.6%). The indicators of coverage of individual types of loans to that sector show a considerably lower coverage of better collateralised loans, such as home and mortgage loans. Higher coverage of the remaining types of loans was due to their distribution in the portfolio of small loans, making it possible for the banks to assess credit risk on a collective basis exclusively according to criteria of timeliness in meeting the obligations.

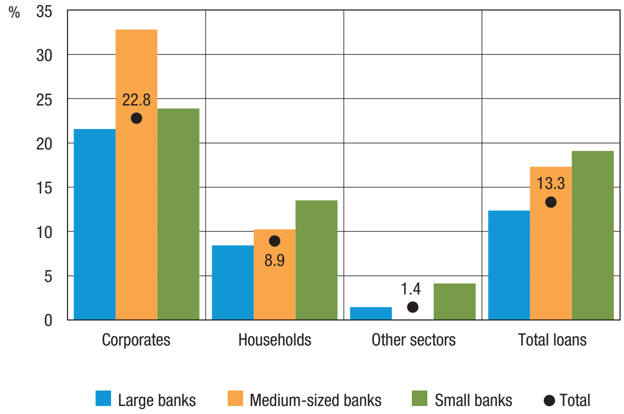
The reported increase in loans to the government sector of 10.2% was entirely due to the fact that the Ministry of Finance took over the shipyards' loans. This effect aside, government credit liabilities fell by 9.1% as the government replaced on the domestic market some of its credit liabilities by liabilities arising from issued securities. Such assumption of credit liabilities covered by guarantees of the Republic of Croatia also led to a fall in corporate loans of 4.1%. The effect of this change aside, corporate loans rose by a small 0.9% as a result of an increase in loans to public enterprises in large banks. At the same time, loans to other corporates fell slightly, with this subsector

Figure 55 Structure of bank partly recoverable and fully irrecoverable loans by activities
as at 30 June 2012



Source: CNB.

Figure 56 Share of bank partly recoverable and fully irrecoverable loans
as at 30 June 2012



Source: CNB.

meeting its liquidity needs by using its deposits, which it reduced by 13.5%.

The fall in loans to manufacturing of 20%, as a result of a fall in shipbuilding activity was the biggest change that took place in the first half of the year. As a result, the share of manufacturing in the distribution of loans fell by 1.6 percentage points, to 8.3%. The assumption of shipyards' loans increased the share of public administration and defence. Due to stagnation in total credit activity, this was the biggest positive change by activities in the first half of the year. The increase in loans was channelled to electricity supply and construction and involved loans granted to two public enterprises by large banks. Loans to mining and quarrying and information and communication rose substantially (12.8% and 8.9%, respectively) although their share in total distribution remained small. Seasonal growth was also seen in loans granted for the preparation of the tourist season and investments in accomodation and food service activities. Despite its economic significance, the share of tourism as an economic activity was relatively stable over a longer period of time and less represented in the distribution of total loans. Manufacturing, trade and construction again accounted for the bulk of the credit portfolio of other corporates.

If loans to public enterprises in this sector are excluded, the first half of 2012 saw a considerable slowdown in the increase in loans to construction. With the continuation of the process that started in the last quarter of the previous year, the strong upward trend from the previous years came to a halt. Loans to corporates dealing with the related real estate business also declined sharply (6.5%), mainly influenced by a range of problems in this activity, particularly lack of price flexibility, vast supply and fallen demand. As a result, household home loans fell for the first time since June 2009 at a semi-annual level. These difficulties were also coupled with growing due but unpaid receivables in these two activities. The rate of growth in due but unpaid receivables held steady at total sector level average, although the analysis of their structure showed that the bulk of these receivables involved B and C categories. All this led to an increase in the share of B and C category loans in total loans of these two activities from 28.9% to 32.9%. Estimated losses again rose very slightly, from 31.1% to 32.5%, probably attributable to instruments of collateral given for these loans.

The biggest changes in the corporate sector by loan types were due to the previously described assumption of loans from shipyards, which led to the biggest fall in loans for working capital and investment loans. However, these loans were again the most widely represented loans in terms of distribution of loans by types, accounting for 35.6% or 26.1% of all loans granted to corporates. The first half of the year saw the biggest increase in the amount of syndicated loans, which is mainly attributable to loans granted by banks to the CBRD and to the corporate involved in the construction and management of state roads, whose loans are covered by state guarantees. Loans of this type thus reached a share of 10.5% in the structure of loans by type. Accounting for 13.3%, only other loans also stood out, despite their small fall in the first half of 2012. Overdraft facilities and loans for payments based on guarantees again grew faster and, combined with growing due but unpaid receivables and original maturity shortening, pointed to persistent difficulties in the business operations of corporates.

The fall in household sector loans was due to a fall in all types of loans except other loans (cash general purpose loans, overdraft facilities and other loans). Down by 15.6%, car purchase loans again played a key role in this fall. A steady fall in these loans' bases led to acceleration in the rate of their fall, with the bulk of decline in these loans involving loans in Swiss francs. Following deceleration in the growth rate of home loans, the key type of household loans, last year, these loans fell by a small 0.1% or by 0.4%, if exchange rate effects are excluded. This fall was almost entirely due to a fall in home loans indexed to the Swiss franc, in contrast with home loans in euro, which rose.

The quality of household loans continued to deteriorate, driven in particular by home loans indexed to the Swiss franc in which B and C category loans reached 8.0%, while the share of B and C category loans in euro loans held steady at 3.3%. B and C category loans accounted for 5.5% of total home loans. At the end of June 2012, a total of 24 users of home loans in Swiss francs deferred their liabilities in accordance with Annex I to the Memorandum on alleviating the position of users of housing loans. The amount of loans negotiated under this Annex accounted for 0.1% of the total home loans in Swiss francs.

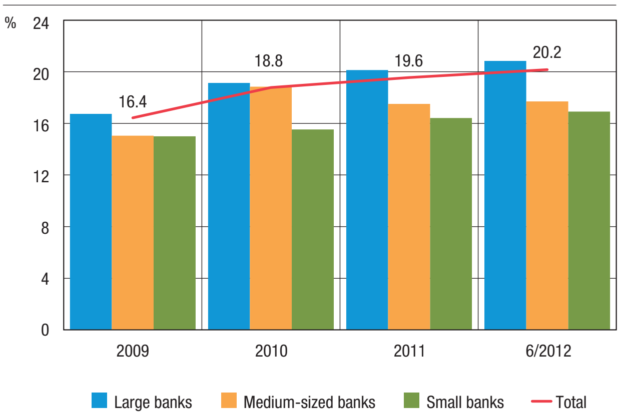
Other household loans also had a large impact on the quality of household loans. In this loan group, the share of B and C category loans was 12.3%. The worsening of the quality of this part of credit portfolio was mainly driven by a 10.2% increase in due but unpaid receivables. The increase in these loans' value adjustments was bigger than the increase in their allocation base, which implies that previously identified losses in the portfolio of non-performing loans have increased. In terms of loan quality, car purchase loans and credit card loans fared better (4.4% and 4.3%, respectively) than home loans. The relatively good quality of car purchase loans can partly be attributed to the fact that most car purchase loans are covered by insurance while the good quality of credit card loans can largely be attributed to one bank's having loan repayments guaranteed by a credit card company.

The fall in total placements and assumed off-balance sheet liabilities was mostly due to a fall in these items' foreign currency component (those indexed included), which in turn led to a fall in exposure to currency induced credit risk, particularly exposures unhedged against this risk. The only significant credit growth in the first half of the year was the banks' syndicated kuna loan to the CBRD. A small increase was also seen in euro home loans, while all other euro loans declined. While the biggest decline was again seen in loans in Swiss francs, the loans in all the remaining currencies also fell. And finally, the share of total bank loans (net) exposed to currency induced credit risk fell by almost 3 percentage points, to 74.7%. The bulk of this amount (91.5%) continued to be unhedged against this risk, having been placed to clients with an unmatched currency position.

10.1.5 Capital adequacy

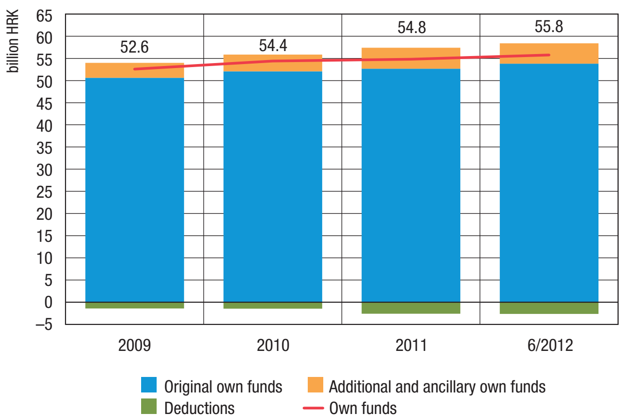
The capital adequacy ratio of banks continued to grow for the fourth consecutive year, reaching 20.17% at the end of June 2012 (Figure 57), its highest value since the end of 2000 (21.27%). The growth in this rate in the first half of 2012 can primarily be attributed to slower business activities of banks and the associated fall in the exposure that is weighted by credit risk. To a smaller extent, it can also be attributed to the retained 2011 profit and its inclusion in the calculation of own funds, with the result that the unused amount of own funds rose to HRK 22.6bn.

Figure 57 Bank capital adequacy ratio
end of period



Note: Basel II has been applied since 31 March 2010. From 31 March 2010 on, the minimum capital adequacy ratio is 12% (10% prior to this date).
Source: CNB.

Figure 58 Bank own funds
end of period



Source: CNB.

The fall in the capital requirement for credit, counterparty credit, dilution and free deliveries risks (hereinafter: capital requirements for credit risk) can mainly be ascribed to the deleveraging efforts seen in almost all sectors and to the continued increased caution of banks in terms of risk assumption, as evidenced by a HRK 5.4bn or 1.3% decline in net exposure weighted by credit risk. Balance sheet exposures fell by 0.8% while off-balance sheet exposures fell by a slightly smaller amount but at a much faster rate (11.4%), thus continuing their downward trend present for the fourth consecutive year. The fall in the average weight for credit risk to 58.5% (Figure 59) also had a small impact on the fall in capital requirements, as a result of a lower weight under the internal ratings based approach (IRB approach).

The capital requirement for credit risk was reduced both under the standardised and the IRB approach, with the developments in the basic determinants of the requirement, the amount of exposure and average weight, remaining opposite.[23] The banks usually use the standardised approach to calculate the amount of exposure weighted by credit risk and only one large bank has the permission from the CNB to use the IRB approach. Therefore, to calculate the capital requirement, the banks used the standardised approach for the bulk or 86.4% of total exposure. The net amount of exposure weighted under the standardised approach fell by 2.7% leading, despite a small increase in the weight, to a fall in the capital requirement for credit risk under the standardised approach. The fall in the institution category resulting from a fall in deposits with the

23 The capital requirement for credit risk is obtained by multiplying the credit risk-weighted exposure by 12% (minimum capital adequacy ratio). The credit risk-weighted exposure amount is obtained by multiplying the exposure that is being weighted by the relevant credit risk weight. Under the standardised approach, prescribed weights are used for specific categories, depending on the external credit risk assessment. Under the IRB approach, the risk components (PD, LGD, EAD, M) are transformed into risk weighted assets and thus into the capital requirement. Some of the risk components are calculated by banks, and the difference between a foundation internal ratings-based approach and an advanced internal ratings-based approach (i.e. FIRB or AIRB) depends on the inputs ensured by the banks by means of their own estimate and those ensured by the supervisor. Some of the inputs ensured by banks under the advanced approach are bigger than under the foundation approach.

Table 8 Own funds, capital requirements and capital adequacy ratio of banks
as at 30 June 2012, in million HRK and %

	Large banks		Medium-sized banks		Small banks		Total	
	Amount	Share	Amount	Share	Amount	Share	Amount	Share
Own funds	46,728.0	100.0	4,527.2	100.0	4,502.4	100.0	55,757.5	100.0
Original own funds	45,648.1	97.7	4,177.8	92.3	3,983.8	88.5	53,809.8	96.5
Paid up capital (excl. cumulative preferential shares) net of own shares	26,462.9	56.6	3,714.2	82.0	3,819.7	84.8	33,996.7	61.0
Reserves and retained earnings	19,352.7	41.4	544.4	12.0	263.9	5.9	20,161.0	36.2
Other	–167.4	–0.4	–80.7	–1.8	–99.8	–2.2	–347.9	–0.6
Additional own funds	3,653.2	7.8	416.9	9.2	532.1	11.8	4,602.1	8.3
Paid-up cumulative preferential shares	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Hybrid and subordinated instruments	3,653.2	7.8	416.9	9.2	554.1	12.3	4,624.1	8.3
Other	0.0	0.0	0.0	0.0	–22.0	–0.5	–22.0	0.0
Items deducted from original own funds and additional own funds	–2,573.3	–5.5	–67.5	–1.5	–13.5	–0.3	–2,654.4	–4.8
Ancillary own funds (for market risk coverage)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Capital requirements	26,910.2	100.0	3,069.3	100.0	3,195.0	100.0	33,174.5	100.0
Credit, counterparty credit and dilution risks and free deliveries	23,889.5	88.8	2,644.2	86.1	2,861.3	89.6	29,395.0	88.6
Standardised approach	20,691.7	76.9	2,644.2	86.1	2,861.3	89.6	26,197.2	79.0
Corporates	9,294.1	34.5	1,169.8	38.1	1,104.9	34.6	11,568.8	34.9
o/w: Secured by real estate property	39.7	0.1	0.1	0.0	50.4	1.6	90.2	0.3
Retail	9,562.7	35.5	1,280.5	41.7	1,408.9	44.1	12,252.1	36.9
o/w: Secured by real estate property	333.6	1.2	12.2	0.4	38.2	1.2	384.0	1.2
Other	1,835.0	6.8	193.9	6.3	347.4	10.9	2,376.3	7.2
IRB approach	3,197.8	11.9	–	–	–	–	3,197.8	9.6
Corporates	1,913.5	7.1	–	–	–	–	1,913.5	5.8
Retail	823.8	3.1	–	–	–	–	823.8	2.5
Settlement/delivery risks	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Position, foreign exchange and commodity risks	439.7	1.6	96.1	3.1	31.6	1.0	567.3	1.7
o/w: Internal models	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Traded debt instruments	272.1	1.0	40.6	1.3	0.4	0.0	313.0	0.9
Foreign exchange	153.4	0.6	10.3	0.3	31.1	1.0	194.8	0.6
Other risks	14.1	0.1	45.3	1.5	0.1	0.0	59.5	0.2
Risk of exceeding the permitted exposure limits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Operational risk	2,581.1	9.6	329.1	10.7	302.2	9.5	3,212.3	9.7
Simplified approach	0.0	0.0	126.1	4.1	274.4	8.6	400.4	1.2
Standardised approach	1,329.6	4.9	203.0	6.6	27.8	0.9	1,560.4	4.7
Advanced measurement approach	1,251.4	4.7	0.0	0.0	0.0	0.0	1,251.4	3.8
Surplus/deficit of own funds	19,817.7	–	1,457.9	–	1,307.4	–	22,583.0	–
Capital adequacy ratio	20.84	–	17.70	–	16.91	–	20.17	–

Source: CNB.

CNB and deposits with foreign banks had a key impact on the fall in exposure. Such developments were associated with CNB measures aimed at boosting economic activity which involve a reduction in the reserve requirement rate in the context of the Economic Development Programme and inclusion of T-bills subscribed at 14 February 2012 auction in the scope of liquid foreign currency claims. Some of the funds previously held by the CNB and foreign banks were channelled to other sectors, but the trend of deleveraging present in almost all sectors led to a fall in total exposure. Under the IRB approach, there was an increase in exposure, with the fall in the capital requirement being attributable to a considerable fall in the average weight for credit risk (46.3%), particularly in the corporate sector category.

Under the standardised approach, the average weight for credit risk rose only slightly and stood at 60.5%. A considerably lower average weight under the IRB approach compared to the standardised approach is primarily due to a much lower

Table 9 Breakdown of net exposure to credit risk by risk weights
as at 30 June 2012, in million HRK

	Retail	Corporates	Central governments and central banks	Institutions	Public sector entities	Local and regional self-government	Collective investment undertakings	Other	Equity investment	Total
STANDARDISED APPROACH										
Total exposure	114,769.2	93,976.8	103,183.4	20,051.9	7,104.5	3,320.3	387.3	17,782.5	–	360,575.8
On-balance sheet items	110,847.5	79,117.5	102,217.6	17,365.3	6,445.3	3,253.5	387.3	17,113.0	–	336,747.0
Off-balance sheet items	3,915.6	14,048.2	680.9	445.0	387.2	66.8	0.0	261.0	–	19,804.8
Securities transactions and long settlement transactions	0.0	361.0	0.1	712.3	271.9	0.0	0.0	408.4	–	1,753.7
Derivative financial instruments	6.2	450.1	284.7	1,529.4	0.0	0.0	0.0	0.0	–	2,270.3
Contracts for novation and other netting agreements	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	–	0.0
Breakdown of total exposure by risk weights										
Weight 0%	0.0	0.0	99,794.6	317.8	4,377.9	0.0	0.0	8,502.6	–	112,992.9
Weight 10%	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	–	0.2
Weight 20%	0.0	25.8	15.1	13,578.6	21.5	370.7	0.0	659.5	–	14,671.2
Weight 35% (residential real estate property)	8,793.3	372.5	0.0	0.0	0.0	0.0	0.0	4.7	–	9,170.5
Weight 50%	244.2	1,242.8	3,330.3	5,555.2	2,703.5	2,942.7	2.0	0.0	–	16,020.8
o/w: Commercial real estate property	244.2	1,242.8	0.0	0.3	0.0	0.0	0.0	0.0	–	1,487.3
Weight 75%	33,901.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	–	33,901.6
Weight 100%	68,540.9	85,488.6	41.6	585.4	0.3	0.8	320.4	8,497.6	–	163,475.7
o/w: Past due items	2,771.1	6,077.9	0.0	1.6	0.0	0.0	0.0	12.7	–	8,863.5
Weight 150%	3,289.2	6,710.1	1.6	15.0	1.3	6.1	64.9	17.1	–	10,105.2
o/w: Past due items	2,787.2	4,744.3	1.2	13.1	1.3	6.0	0.0	7.1	–	7,560.2
Other risk weights	0.0	137.0	0.0	0.0	0.0	0.0	0.0	100.8	–	237.7
Credit risk mitigation techniques – substitution effects										
Total outflow	–1,253.7	–5,726.1	–6.0	–400.9	–16,420.6	–33.1	0.0	–103.8	–	–23,944.3
Total inflow	22.0	188.6	19,237.2	339.4	101.5	716.4	0.0	1,910.2	–	22,515.3
IRB APPROACH										
Total exposure	18,612.6	18,833.1	17,578.8	1,685.4	–	–	–	–	111.6	56,821.5
On-balance sheet items	18,071.6	17,262.4	17,395.8	1,202.6	–	–	–	–	111.6	54,044.1
Off-balance sheet items	540.9	1,502.8	183.0	12.0	–	–	–	–	–	2,238.7
Securities transactions and long settlement transactions	0.0	38.5	0.0	322.9	–	–	–	–	–	361.4
Derivative financial instruments	0.0	29.4	0.0	147.9	–	–	–	–	–	177.3
Contracts for novation and other netting agreements	0.0	0.0	0.0	0.0	–	–	–	–	–	0.0
Credit risk mitigation techniques – effects of PD adjustment										
Total outflow	0.0	–176.2	0.0	0.0	–	–	–	–	0.0	–176.2
Total inflow	0.0	0.0	1,589.4	15.8	–	–	–	–	0.0	1,605.2

Source: CNB.

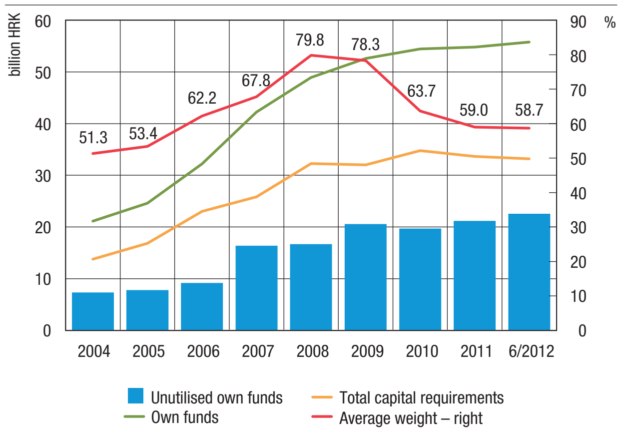
weight in the retail category, which stood at 36.9% under the IRB and 89.0% under the standardised approach. The growth in the average weight under the standardised approach is the result of a decline in the share of exposure weighted by 20%, mostly involving exposures in the institutions category and an increase in the share of exposures with 100% and 150% weights. Exposures weighted by a 100% risk weight fell at a rate that was considerably slower than the rate of fall in total exposure, with their share in the distribution of exposure that is being weighted rising slightly. The share of the high-risk weight of 150% rose due to a considerable increase in the amount of due but unpaid receivables (whose value adjustments were below 20% of the unsecured part of total exposure). Due but unpaid receivables in the 100% weight category

Table 10 Breakdown of bank capital adequacy ratio
end of period

	Dec. 2009		Dec. 2010		Dec. 2011		Jun. 2012	
	Number of banks	Share in bank assets (%)	Number of banks	Share in bank assets (%)	Number of banks	Share in bank assets (%)	Number of banks	Share in bank assets (%)
Ratio lower than 10%	0	0.0	3	1.0	0	0.0	0	0.0
Ratio from 10% to 12%	6	5.8	0	0.0	1	0.5	0	0.0
Ratio from 12% to 15%	11	25.9	9	13.2	9	9.5	9	7.2
Ratio from 15% to 20%	9	55.3	11	55.2	13	34.6	13	37.0
Ratio higher than 20%	8	13.0	10	30.6	9	55.4	10	55.9

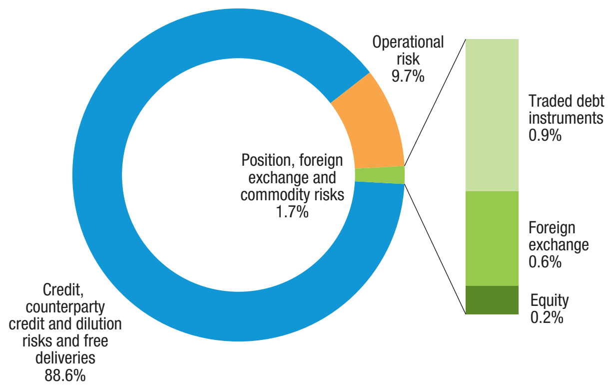
Note: From 31 March 2010 on, the minimum capital adequacy ratio is 12% (10% prior to this date).
Source: CNB.

Figure 59 Average credit risk weight



Source: CNB.

Figure 60 Structure of bank total capital requirements
as at 30 June 2012



Source: CNB.

(value adjustments above 20% of the unsecured part of total exposure) also rose noticeably.

The capital adequacy ratio of banks was much higher than the minimum prescribed 12%, mainly owing to high values in large banks. At the end of the first half of 2012, the capital adequacy ratio stood at 20.84% in the group of large banks, 17.70% in the group of medium-sized banks and at 16.91% in the group of small banks (Table 8). The capital adequacy ratio rose in all bank groups from the end of 2011, driven in large banks as well as at the level of all banks, by the reduction in the capital requirement, and in the remaining two bank groups by growth in own funds, which was due in medium-sized banks to the retained profits from 2011, and in small banks to recapitalisation efforts. Three banks were recapitalised by share payments in cash while two increased their share capital by converting hybrid instruments into shares. Thus, at the end of the observed period, all the banks had a capital adequacy ratio above 12% and in only one of them was this ratio below 14%. Ten banks, whose assets accounted for over one half of the total assets of all banks, had a capital adequacy ratio above 20% (Table 10).

By June 2012, nine banks, of which five were large banks, either paid out dividends or voted for dividend payments in the total amount of HRK 1.8bn, or almost one half of the amount of profit generated by banks in 2011. The remaining amount of profit retained helped keep the trend of growth in own funds which, though small, strengthened the already healthy capital base. Balance sheet capital to liabilities ratio stood at 14.0%, attesting, together with the capital adequacy ratio of original own funds of 18.54%, to the good quality of capital. The original own funds comprise high quality elements (ordinary and non-cumulative preferential shares, retained earnings and reserves, while no hybrid instruments are allowed) so it was not surprising that the study of the quantitative impact of the introduction of Basel III[24] showed that domestic banks, both in terms of the amount and quality of capital, were ready to embrace the new regulatory framework. Additional own funds accounted for only a small share of own funds, falling additionally during the observed period. Deduction items also had a negative impact on the level of own funds, with their amount rising due to a greater shortfall in provisions under the IRB approach.

Unlike the capital requirement for credit risk that fell by HRK 537.7m or 1.8%, other capital requirements, i.e. the requirement for market and operational risk rose. While the growth in the capital requirement for operational risk was negligible, the capital requirement for market risks rose by a considerable 14.1%. Such changes led to a fall in the total capital requirement of HRK 466.5m or 1.4%. The growth in the

24 See Results of the quantitative impacts study of the draft Capital Requirements Regulation and Directive, CNB, September 2012, www.hnb.hr.

capital requirement for market risk was influenced by a significant growth in the currency risk component, largely as a result of changes in one large bank that had significantly increased its short position in euro on account of forward transactions in that currency. Despite an increase in the capital requirement for market risks, its share remained low, standing at 1.7% of the total capital requirement (Figure 60), with the requirement for position risk of debt instruments accounting for the biggest share of the total. Ten banks, or all large and medium-sized banks and one small bank, had to calculate the capital requirement for trading book positions, while the remaining banks were not required to do so because of the insignificant value of their trading book positions. Not a single bank used the internal approach to calculate the capital requirement for market risks.

The share of the capital requirement for operational risks rose slightly, reaching 9.7% of the total capital requirement. Seven banks used the standardised approach to calculate the capital requirement for operational risk, and since four of them were large banks, most of the requirement was calculated using this approach. Two large banks used the advanced approach (having been granted permission by the CNB) while all the remaining banks used the basic indicator approach, which accounted for the smallest share of the capital requirement for operational risk. A very small change in the capital requirement for operational risk compared to the end of 2011 was due to the fact that in their calculations, both under the basic indicator approach and under the standardised approach, at the end of the first half of 2012, the banks used the same level of the average relevant indicator which depends on the average operating income of banks in the past three years.[25]

10.2 Housing savings banks

At the end of the first half of 2012, there were five housing savings banks operating in the Republic of Croatia, the ownership structure of which remained unchanged from the previous period. One housing savings bank was in majority domestic ownership and the remaining four in the majority (direct or indirect) ownership of foreign shareholders. The assets of housing savings banks in majority foreign ownership accounted for 95.9% of the total assets of all housing savings banks.

10.2.1 Balance sheet

The total assets of housing savings banks at the end of June 2012 stood at HRK 7.3bn (Table 11), and accounted for 1.8% of the total assets of credit institutions. Compared to the end of 2011, housing savings banks' assets shrank by 7.0%, with three housing savings banks reporting a fall and two reporting a small increase in assets. The fall in the balance sheet amount was largely due to a decline in loans received from domestic financial institutions, while lower funding sources were mostly reflected in a fall in housing savings banks securities

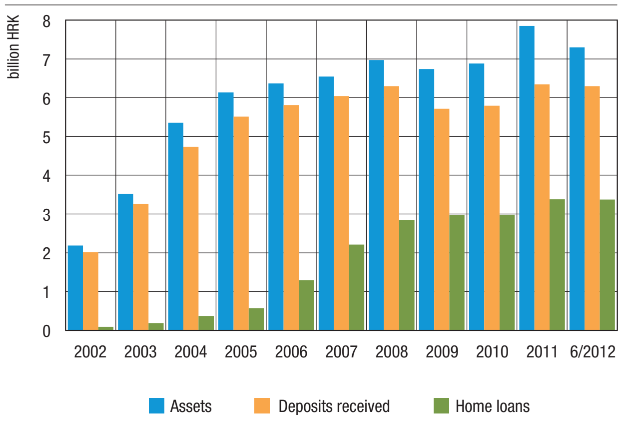
Table 11 Structure of housing savings bank assets
end of period, in million HRK and %

	Dec. 2009		Dec. 2010			Dec. 2011			Jun. 2012		
	Amount	Share	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
Money assets and deposits with the CNB	0.0	0.0	0.0	0.0	–28.6	0.0	0.0	60.0	0.0	0.0	–58.3
Money assets	0.0	0.0	0.0	0.0	–28.6	0.0	0.0	60.0	0.0	0.0	–58.3
Deposits with the CNB	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Deposits with banking institutions	177.8	2.6	185.0	2.7	4.1	669.7	8.5	262.1	738.1	10.1	10.2
MoF treasury bills and CNB bills	295.4	4.4	570.6	8.3	93.2	668.1	8.5	17.1	866.2	11.9	29.6
Securities and other financial instruments held for trading	0.0	0.0	0.0	0.0	0.0	194.0	2.5	0.0	204.0	2.8	5.2
Securities and other financial instruments available for sale	71.5	1.1	137.4	2.0	92.3	210.4	2.7	53.1	206.9	2.8	–1.6
Securities and other financial instruments held to maturity	794.5	11.8	798.6	11.6	0.5	820.4	10.5	2.7	640.7	8.8	–21.9
Securities and other financial instruments not traded in active markets but carried at fair value	99.7	1.5	101.6	1.5	1.9	99.9	1.3	–1.6	18.8	0.3	–81.2
Derivative financial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans to financial institutions	117.0	1.7	73.6	1.1	–37.1	90.9	1.2	23.5	14.0	0.2	–84.6
Loans to other clients	4,847.8	71.9	4,689.1	68.1	–3.3	4,756.1	60.6	1.4	4,406.4	60.4	–7.4
Investments in subsidiaries and associates	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreclosed and repossessed assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Tangible assets (net of depreciation)	7.5	0.1	7.2	0.1	–3.5	6.2	0.1	–14.1	6.3	0.1	2.2
Interest, fees and other assets	383.2	5.7	368.3	5.4	–3.9	386.9	4.9	5.0	247.4	3.4	–36.1
Net of: Collectively assessed impairment provisions	55.9	0.8	50.8	0.7	–9.0	56.1	0.7	10.4	52.2	0.7	–7.0
Total assets	6,738.5	100.0	6,880.6	100.0	2.1	7,846.5	100.0	14.0	7,296.7	100.0	–7.0

Source: CNB.

25 Under the basic indicator approach, the initial capital requirement for operational risk stood at 15% of the average relevant indicator while under the standardised approach, the average relevant indicator for individual business lines is multiplied by the relevant rate of the initial capital requirement, which is prescribed at the rate of between 12% and 18%.

Figure 61 Assets, deposits and loans of housing savings banks
end of period



Source: CNB.

investments. The main activity of housing savings banks, i.e. deposit-taking from housing saving banks savers and granting of housing loans fell slightly, as seen in a fall in deposits of housing savings banks savers and credit activity weakening.

Unlike changes in balance sheet structure in 2011 associated with the beginning of the application of the regulation on interest rate risk in the non-trading book, the developments in the balance sheet of housing savings banks in the first half of 2012 were mostly attributable to adjusted input data in the calculation of the economic value of the non-trading book. Such models are based on the inclusion of the effects of rollover of housing savings agreements' into the next savings cycle, and their use reduced the need of housing savings banks for long-term funding sources. Until the end of the observed period, four housing savings banks used the adjusted models to calculate exposure to interest rate risk in the non-trading book, reducing exposure to this risk at the level of the group to 2.4% of own funds. In the calculation of the internal capital requirement, the housing savings banks were again obligated to apply the provisions prescribed by the Decision on the management

Table 12 Structure of housing savings bank liabilities and capital
end of period, in million HRK and %

	Dec. 2009		Dec. 2010			Dec. 2011			Jun. 2012		
	Amount	Share	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
Loans from financial institutions	134.6	2.0	183.1	2.7	36.0	458.9	5.8	150.7	0.0	0.0	–100.0
Short-term loans	134.5	2.0	183.0	2.7	36.0	172.7	2.2	–5.6	0.0	0.0	–100.0
Long-term loans	0.1	0.0	0.1	0.0	–31.9	286.2	3.6	371,598.7	0.0	0.0	–100.0
Deposits	5,713.3	84.8	5,791.5	84.2	1.4	6,345.2	80.9	9.6	6,296.1	86.3	–0.8
Giro account and current account deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Savings deposits	0.0	0.0	172.8	2.5	–	154.1	2.0	–10.8	107.2	1.5	–30.4
Time deposits	5,713.3	84.8	5,618.7	81.7	–1.7	6,191.0	78.9	10.2	6,188.9	84.8	0.0
Other loans	0.0	0.0	0.0	0.0	0.0	94.1	1.2	0.0	93.9	1.3	–0.3
Short-term loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term loans	0.0	0.0	0.0	0.0	0.0	94.1	1.2	0.0	93.9	1.3	–0.3
Derivative financial liabilities and other financial liabilities held for trading	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt securities issued	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Short-term debt securities issued	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term debt securities issued	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Subordinated instruments issued	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Hybrid instruments issued	96.1	1.4	96.7	1.4	0.6	97.7	1.2	1.0	97.5	1.3	–0.1
Interest, fees and other liabilities	375.1	5.6	344.6	5.0	–8.1	368.3	4.7	6.9	277.0	3.8	–24.8
Total liabilities	6,319.2	93.8	6,415.9	93.2	1.5	7,364.1	93.9	14.8	6,764.6	92.7	–8.1
Share capital	487.9	7.2	487.9	7.1	0.0	487.9	6.2	0.0	487.9	6.7	0.0
Current year profit/loss	49.4	0.7	17.1	0.2	–65.4	10.6	0.1	–38.1	33.0	0.5	212.2
Retained earnings/loss	–50.0	–0.7	–1.3	0.0	–97.4	15.0	0.2	–	25.1	0.3	67.2
Legal reserves	4.8	0.1	5.5	0.1	13.7	6.2	0.1	14.0	6.7	0.1	7.6
Reserves provided for by the articles of association and other capital reserves	0.1	0.0	10.9	0.2	–	9.2	0.1	–16.3	5.2	0.1	100.0
Unrealised gains/losses on value adjustments of financial assets available for sale	–72.9	–1.1	–55.3	–0.8	–24.1	–46.5	–0.6	–15.9	–25.8	–0.4	–44.4
Reserves arising from hedging transactions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Previous year profit/loss	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total capital	419.3	6.2	464.8	6.8	10.8	482.4	6.1	3.8	532.1	7.3	10.3
Total liabilities and capital	6,738.5	100.0	6,880.6	100.0	2.1	7,846.5	100.0	14.0	7,296.7	100.0	–7.0

Source: CNB.

of interest rate risk in the non-trading book[26], which does not envisage the use of adjusted models.

The biggest change in housing savings banks' assets from the end of 2011 involved a fall in securities investments of HRK 382.0m or 12.3%. This was exclusively due to a fall in investments in bonds of the Republic of Croatia, while a relatively large increase in investments in MoF T-bills (29.6%), on account of a small nominal amount, had no significant impact on the total change in securities. The bonds of the Republic of Croatia and T-bills of the Ministry of Finance were the only types of securities held by housing savings banks in their portfolios.

A part of the fall in housing savings banks' securities investments involved the bonds distributed in the loans and receivables portfolio, which increased the intensity of the decline in net loans in the assets of housing savings banks. This effect excluded, the fall in net loans at the level of the housing savings bank group was much smaller and stood at 2.0%, and mostly involved a reduction in loans to central government funds clients[27] and banks and to a lesser extent home loans (0.1%). At the end of the first half of 2012, home loans granted by housing savings banks stood at HRK 3.3bn (net), accounting for 5.5% of total home loans of all credit institutions.

The fall in housing savings banks liabilities, mainly attributable to an 83.0% fall in loans received, led to a considerable decline in the share of received loans in the sources of funding, to only 1.3%. Compared to the end of 2011, the main source of housing savings banks financing, deposits of housing savings banks savers, fell by 0.8%, to only slightly below HRK 6.1bn. These deposits made up almost the total deposits of housing savings banks, with 55.6% of their amount at the end of 2012 being placed to housing savings banks savers in the form of home loans. Despite the highest home loans to housing savings ratio ever, its growth in the past four years was very modest.

The balance sheet capital of housing savings banks rose by 10.3% or HRK 49.7m from the end of 2011, raising its share in assets to 7.3% (Table 12). As the housing savings banks did not increase their share capital in the first half of 2012, the increase in capital was based predominantly on current year profit and a reduction in unrealised losses on value adjustment of financial assets available for sale.

These changes had a positive impact on own funds, which were up by a small 1.0% and reached HRK 563.8m. The capital requirement for the coverage of operating risks rose slightly faster (2.0%), slightly reducing the capital adequacy ratio compared to the end of 2011, which stood at 19.68% at the end of the first half of 2012.

10.2.2 Income statement

At the end of the first half of 2012 housing savings banks had generated HRK 38.4m in pre-tax profit, an increase of 240.4% from the same period previous year (Table 13). Fast growth in housing savings bank profit was mainly due to an increase in net operating income and a positive contribution of income from repealed provisioning costs and reduced operating expenses. One housing savings bank generated a loss of HRK 4.1m while all the remaining housing savings banks operated with a considerably higher profit than at the end of the first half of 2011.

26 OG 2/2010, 34/2010 and 37/2012.

27 This includes entities financed by special extrabudgetary taxes such as Croatian Institute for Health Insurance, Croatian Pension Insurance Administration, Croatian Motorways, Croatian Roads, etc.

Table 13 Housing savings bank income statement

in million HRK

	Jan.–Jun. 2011	Jan.–Jun. 2012
Net interest income	57.3	67.4
Total interest income	162.3	183.5
Total interest expenses	105.0	116.1
Net income from fees and commissions	27.2	28.0
Total income from fees and commissions	31.6	32.7
Total expenses on fees and commissions	4.5	4.8
Net other non-interest income	–1.1	5.4
Other non-interest income	6.5	14.7
Other non-interest expenses	7.7	9.3
Net non-interest income	26.0	33.4
General administrative expenses and depreciation	66.7	64.4
Net operating income before loss provisions	16.6	36.3
Total expenses on loss provisions	5.3	–2.0
Expenses on value adjustments and provisions for identified losses	0.6	1.9
Expenses on collectively assessed impairment provisions	4.7	–3.9
Income/loss before taxes	11.3	38.4
Income tax	2.4	5.3
Current year profit/loss	8.8	33.0

Source: CNB.

At the end of the first half of 2012, net income of housing savings banks rose by a considerable 21.0% or HRK 17.5m from the same period of the previous year. This was largely due to an increase in net interest income of 17.6% or HRK 10.1m and an increase in net non-interest income of 28.3% or HRK 7.4m. Unlike banks, housing savings banks reported an increase in all types of interest income, with the largest nominal increase coming from interest income on home loans (HRK 10.2m or 12.7%). The increase in non-interest income was mainly attributable to income from securities trading while increased income from fees and commissions also had a small impact on net income.

Operating expenses of housing savings banks rose moderately, with the fastest growth being seen in expenses on received deposits (13.7m or 16.2%). This increase was largely due to the costs of deposits received from the banks (HRK 8.0m), followed by the costs of deposits received from housing savings bank savers (HRK 5.6m or 6.7%). Operating expenses, i.e. general administrative expenses and depreciation fell by 3.5% from the end of the first half of 2011, mainly as a result of a fall in employee expenses.

Changes in the amount of expenses on loss provisions were mainly due to a fall in securities investments, which in turn led to a fall in total risk category A placements, in which the bulk of securities are normally distributed. This led to a fall in placements that are subject to collectively assessed impairment provisions. By repealing provisions, the housing savings banks generated profit, in contrast with the same period previous year when they reported expenses on this basis. By repealing provisions for risk category A, the housing savings banks generated profit, in contrast with the same period previous year when

Table 14 Classification of housing savings bank placements and assumed off-balance sheet liabilities by risk categories
end of period, in million HRK and %

Risk category	Dec. 2009		Dec. 2010			Dec. 2011			Jun. 2012		
	Amount	Share	Amount	Share	Change	Amount	Share	Change	Amount	Share	Change
A	6,385.1	99.6	5,947.7	99.5	–6.8	6,423.0	99.5	8.0	5,878.9	99.5	–8.5
B-1, B-2 and B-3	18.8	0.3	31.5	0.5	67.9	27.8	0.4	–11.6	27.7	0.5	–0.6
C	4.2	0.1	1.4	0.0	–67.6	2.0	0.0	49.6	2.1	0.0	3.3
Total	6,408.1	100.0	5,980.6	100.0	–6.7	6,452.9	100.0	7.9	5,908.6	100.0	–8.4

Source: CNB.

they reported expenses on this basis. Income deriving from the repeal of loss provisions for category A surpassed the increase in expenses on loss provisions for categories B and C, and this had a positive influence on the profit of housing savings banks.

The sharp increase in profit in the first half of 2012 significantly boosted housing savings banks' profitability, with their profitability indicators reaching the recommended values. The return on average assets of housing savings banks thus rose from only 0.2% at the end of 2011 to over 1.0% at the end of June 2012 while the return on average equity rose from 2.2% to over 13.0% during the same period. The cost-to-income ratio also improved, with the ratio of general administrative expenses and depreciation and net income falling from 85.3% to 64.0%. Despite significant improvement, at 49.6% the level of this indicator was still above bank average. At the end of the first half of 2012, a housing savings bank employee managed on average HRK 17.6m in assets, which was slightly less than in banks.

Table 15 Coverage of housing savings bank total placements and assumed off-balance sheet liabilities by total value adjustments and provisions
end of period, in million HRK and %

	Dec. 2009	Dec. 2010	Dec. 2011	Jun. 2012
Total value adjustments against placements and provisions for assumed off-balance sheet liabilities	64.2	57.3	62.3	58.9
Value adjustments and provisions	8.1	6.2	5.9	6.4
Collectively assessed value adjustments and provisions	56.2	51.0	56.4	52.5
Total placements and assumed off-balance sheet liabilities	6,408.1	5,980.6	6,452.9	5,908.6
Coverage	1.00	0.96	0.97	1.00

Source: CNB.

10.2.3 Credit risk

At the end of the first half of 2012, 83.5% of the total housing savings banks' capital requirements went to the coverage of credit risk. Despite a fall in credit risk exposure, the capital requirement rose slightly from the end of 2011 as a result of changes in the structure of exposure weighted by credit risk. The amount of balance and off-balance sheet items exposed to credit risk fell to HRK 5.9bn, a decline of HRK 544.3m or 8.4% from the end of 2011. This decline mostly involved securities investments and to a lesser extent the slower credit activities of housing savings banks. The quality of placements and off-balance sheet liabilities remained unchanged, while the coverage of items classified into risk categories B and C by value adjustments and provisions rose slightly.

A fall in the debt securities that are included in the scope of placements had a predominant effect on the fall in risk category A placements, which totalled 8.5% (Table 14). Since the changes in other risk categories were almost negligible, the quality of total placements remained at end-2011 level. Housing savings banks again classified the bulk (99.5%) of total placements and assumed off-balance sheet liabilities into the best quality risk category A, and the remaining 0.5% of placements and assumed off-balance sheet liabilities into risk categories B and C. In terms of quality, home loans again fared worse than total placements. The share of B and C category placements of home loans stood at 0.9%, as at the end of 2011.

Despite the fact that the quality of home loans remained unchanged, housing savings banks increased value adjustments for these loans which led to a small increase (21.4%) in the coverage of total placements and off-balance sheet liabilities of B and C risk categories by value adjustments and provisions. Since total placements and off-balance sheet liabilities are predominantly classified into risk category A, the bulk of total value adjustments and provisions were again accounted for by collectively assessed provisions for losses and their fall of 6.9% from the end of 2011 was due to the already mentioned fall in risk category A placements (Table 15).

11 Foreign reserves management

The Croatian National Bank manages the international reserves of the Republic of Croatia; under the Act on the Croatian National Bank, these reserves constitute a part of the central bank balance sheet. The manner in which the international reserves are managed is consistent with the established monetary and foreign exchange policies. In managing the international reserves, the CNB is governed primarily by the principles of liquidity and safety. The international reserves of the Republic of Croatia comprise all claims and banknotes in a convertible foreign currency as well as special drawing rights.

11.1 Institutional and organisational framework, management principles, risks and manner of international reserves management

11.1.1 Institutional and organisational framework for international reserves management

The Council of the CNB formulates the strategy and policy of international reserves management and approves the risk management framework. The International Reserves Commission develops the international reserves investment strategies in accordance with the objectives and criteria set by the CNB Council and adopts tactical decisions on international reserves management, while taking account of market conditions.

11.1.2 Principles of and risks in international reserves management

The central bank manages international reserves in accordance with the principles of security and liquidity of investment (Article 19 of the Act on the Croatian National Bank). In doing so, it maintains high liquidity of the reserves and appropriate risk exposure and seeks, within the given restrictions, to ensure favourable rates of return on its investments.

The risks present in international reserves management are primarily financial risks, such as credit, interest rate and currency risks, though other risks, such as liquidity and operational risks also play a role. The CNB limits exposure to credit risk by investing in highly rated government bonds, collateralised deposits and non-collateralised deposits in financial institutions with only the highest credit rating. Interest rate risk, i.e. the risk of a fall in the value of the international reserves portfolio due to a potential increase in interest rates, can be controlled by means of the so-called benchmark portfolios, as well as by investing a portion of international reserves in the held-to-maturity portfolio. Currency risk arises from currency fluctuations between the kuna and the euro and between the kuna and the US dollar. Liquidity risk can be controlled by investing the reserves in easily marketable bonds and, partly, in short-term deposit instruments. Operational risk can be controlled by strict separation of functions and responsibilities, precisely defined methodologies and procedures, and regular internal and external audits.

11.1.3 Manner of international reserves management

Pursuant to the Decision on international reserves management, the Croatian National Bank manages international reserves in two ways: in line with its own guidelines and in accordance with assumed obligations, depending on the manner of international reserves formation.

The CNB manages international reserves in line with its own guidelines in that part formed on the basis of definitive purchases of foreign currency from banks and the Ministry of Finance, the International Monetary Fund membership, and investment income from international reserves and other assets owned by the CNB. The other portion of international reserves, formed on the basis of the allocated foreign currency component of reserve requirements, deposits of the Ministry of Finance, repo agreements with banks, swap interventions in the domestic foreign exchange market, IMF membership and other assets owned by other legal entities, is managed by the CNB in accordance with assumed obligations, with the aim of providing protection against currency and interest rate risks.

The portion of international reserves managed by the CNB in line with its own guidelines can be kept in held-for-trading and held-to-maturity portfolios. The held-for-trading portfolios comprise held-for-trading financial instruments, which are important for maintaining daily liquidity of international reserves. The minimum daily liquidity and held-for-trading instruments used for daily liquidity maintenance are prescribed by a Governor's decision. The held-for-trading portfolios are carried at market (fair) value through the profit and loss account. The held-to-maturity portfolios comprise fixed income and fixed maturity securities that the CNB intends to hold and can hold until maturity, carried at amortised cost.

The terminology of reporting on international reserves of the CNB also includes the terms 'gross' and 'net reserves'. Gross reserves imply total international reserves. Net reserves include the portion of reserves managed by the CNB in line with its own guidelines.

11.2 International reserves in the first half of 2012

The first half of 2012 was marked by further deepening of the debt crisis in Europe, the downgrading of the credit ratings of a number of countries and banks, as well as a fall in yields on the safest government bonds of countries such as Germany, France and Austria, to their all-time lows, and even, for some maturities, to below the zero level. Despite a wide range of measures[28] introduced by the Fed and ECB in order to stabilise financial markets, prevent a slowdown in economic activity and restore investor confidence, the strong demand for the safest investments continued. Against this background and given general uncertainty and flight to safe havens, yields on even the government bonds of countries with the highest credit ratings continued to decline.

28 After the key interest rates of the US and European central banks had fallen to exceptionally low levels, the Fed and ECB adjusted some of their current monetary policy instruments (e.g. discount window loans, prolongation of maturity of refinancing operations, extension of the list of securities eligible as collateral, etc.) and introduced some new unconventional instruments (loans to key credit market participants, loans to systemically important institutions, interventions in government bond markets etc.).

Table 16 Monthly changes in total and net CNB international reserves

end of period, in million EUR

Month	Total reserves	Net reserves
December 2011	11,194.67	10,022.13
November 2012	10,916.56	9,705.96
February 2012	11,410.60	9,937.46
March 2012	11,339.86	9,959.22
April 2012	12,461.71	9,988.76
May 2012	12,105.86	10,348.93
June 2012	11,635.07	10,420.49
Change		
Jun. 2012 – Dec. 2011	440.4	398.36

Source: CNB.

Table 18 CNB foreign exchange interventions with banks – the first half of 2011 compared to the first half of 2012

in million EUR

	Purchase (1)		Sale (2)		Net (1 – 2)	
	Jan.–Jun. 2011	Jan.–Jun. 2012	Jan.–Jun. 2011	Jan.–Jun. 2012	Jan.–Jun. 2011	Jan.–Jun. 2012
January	0.00	0.00	0.00	327.00	0.00	–327.00
February	0.00	0.00	0.00	131.00	0.00	–131.00
March	0.00	0.00	0.00	0.00	0.00	0.00
April	0.00	0.00	0.00	0.00	0.00	0.00
May	0.00	0.00	0.00	266.40	0.00	–266.40
June	0.00	0.00	0.00	0.00	0.00	0.00
Total	0.00	0.00	0.00	724.40	0.00	–724.40

Source: CNB.

Table 17 Total CNB turnover in the foreign exchange market, 1 January – 30 June 2012

at the exchange rate applicable on the value date, in million

	Purchase (1)		Sale (2)		Net (1 – 2)	
	EUR	HRK	EUR	HRK	EUR	HRK
Domestic banks	0.00	0.00	724.40	5,473.54	–724.40	–5,473.54
Ministry of Finance	1,014.82	7,654.54	0.00	0.00	1,014.82	7,654.54
Total	1,014.82	7,654.54	724.40	5,473.54	290.42	2,181.00

Source: CNB.

Total international reserves of the CNB as at 30 June 2012 stood at EUR 11,635.07m, up EUR 440.40m or 3.9% on the balance at the last day of 2011 (EUR 11,194.67m). Net international reserves, excluding the foreign currency component of reserve requirements, special drawing rights (SDR) with the IMF, and deposits of the Ministry of Finance of the Republic of Croatia, increased by EUR 398.36m (4.0%) in the first six months of 2012, from EUR 10,022.13m to EUR 10,420.49m. The main drivers of changes in international reserves during the first half of 2012 were foreign currency purchases from the Ministry of Finance and foreign currency sales to banks through interventions.

11.2.1 Total CNB turnover in the foreign exchange market in the first half of 2012

In the first six months of 2012, the Croatian National Bank intervened in the domestic foreign exchange market through foreign currency purchases from the Ministry of Finance and foreign currency sales to banks in the Republic of Croatia.

By intervening in the domestic foreign exchange market in January, February and May 2012, the Croatian National Bank sold to banks a total of EUR 724.40m, which led to a kuna liquidity decline of HRK 5,473.54m. There were no foreign currency purchases from banks.

The CNB purchased EUR 1,014.82m from the Ministry of Finance, while there were no foreign currency sales to the MoF. As a result, HRK 7,654.54m was put into circulation.

11.2.2 Structure of international reserves investment

The CNB invests funds with financial institutions and in countries with the highest credit ratings. The assessment of their creditworthiness is based on the ratings issued by large, internationally recognised rating agencies (Moody's, Standard & Poor's and FitchRatings) and on an iternal creditworthiness assessment model.

There are restrictions on investments with certain financial institutions and in certain countries, as well as in certain instruments, which serves to diversify credit risk.

The bulk of the CNB's foreign currency portfolios is invested in government securities of selected countries, instruments issued by international financial institutions and reverse repo agreements collateralised by government bonds.

Table 19 Structure of international reserves investment according to credit risk as at 30 June 2012

in %

Investment	30 June 2012		31 December 2011	
	Net reserves	Total reserves	Net reserves	Total reserves
1 Countries				
Government bonds	71.25	63.81	73.34	65.65
Reverse repo agreements	8.84	11.23	1.40	1.25
Central banks	2.55	3.62	15.56	21.19
Covered bonds	1.96	1.75	2.06	1.85
2 International financial institutions	10.79	12.85	6.42	8.97
3 Banks				
Deposits	0.87	0.78	1.22	1.09
Securities	3.75	5.96	0.00	0.00
Total	100.00	100.00	100.00	100.00

Source: CNB.

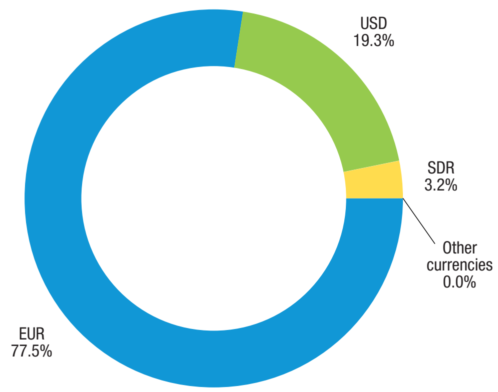
Special attention is paid to credit risk diversification by debt issuers – countries in whose securities and other instruments the CNB may invest international reserves. A fall in credit ratings and the growth in yields on (the fall in the price of) government bonds of some eurozone member countries, due to the deepening of the debt crisis in Europe and rising insecurity in financial markets justified the decision to tighten the rules on investment in certain countries and banks.

Currency structure of international reserves

As at 30 June 2012, the euro accounted for 77.47% of total international reserves, up from 75.93% at the end of 2011. The share of the US dollar decreased in the reference period, from 20.84% at the end of 2011 to 19.34% on the last day of June 2012. The share of SDRs also decreased, from 3.22% to 3.19% of total international reserves, mostly due to an increase in total reserves.

The portion of the reserves accumulated from allocated foreign currency reserve requirement, MoF funds and repo operations with foreign banks is not exposed to currency risk, but it is invested in the same currency in which it was deposited in CNB accounts, i.e. in the currency in which the liability is payable.

Figure 62 Currency structure of total international reserves
as at 30 June 2012

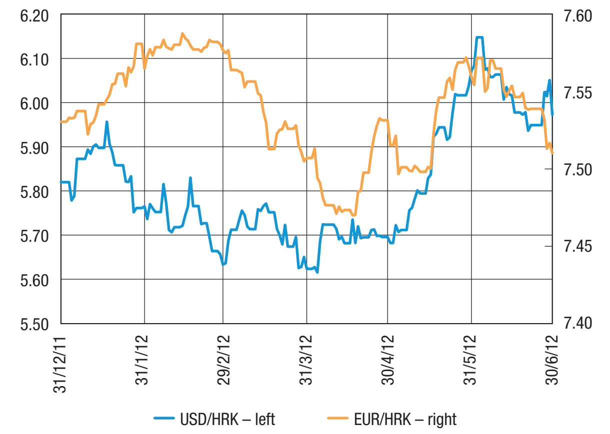


Source: CNB.

Foreign exchange gains and losses on CNB foreign currency portfolios in the first half of 2012

The financial performance of all central banks, including the CNB, depends on the volume and structure of assets and liabilities. The CNB belongs to a group of banks with a large share of international reserves in their assets. As at 31 December 2011, the share of total international reserves in CNB assets was as high as 99.98%, with the bulk of liabilities denominated in kuna. One of the consequences of this currency structure of assets and liabilities is the CNB's exposure to a significant currency risk, i.e. the risk of a change in the currency price of investments in relation to the reporting currency – the kuna. Foreign exchange gains and losses arising from fluctuations in the EUR/HRK and USD/HRK exchange rates have a direct impact on the income and expense calculation reported in kuna in the CNB Income Statement.

Figure 63 Daily changes in USD/HRK and EUR/HRK exchange rates in the first half of 2012



Source: CNB.

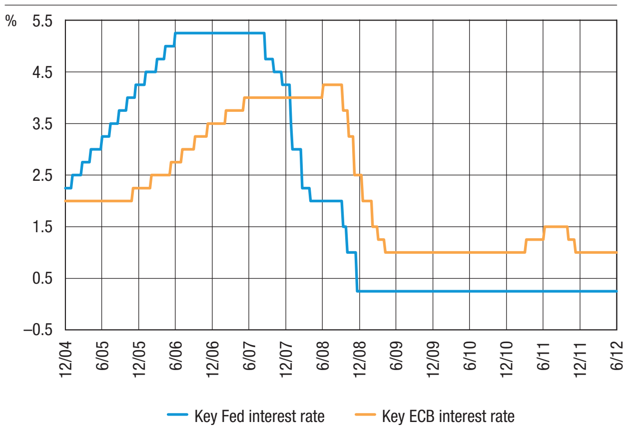
In the first six months of 2012, the EUR/HRK exchange rate decreased slightly from 7.53 to 7.51 (–0.27%), with the result that foreign exchange gains on the CNB euro portfolio were negative and totalled –HRK 188m. The US dollar strengthened from 5.820 to 5.972 (2.62%) in the same period. Foreign exchange gains on the US dollar portfolio were positive and totalled HRK 372m in the first half of 2012.

As a result of fluctuations on the EUR/HRK and USD/HRK exchange rates, and exchange rate differentials resulting from the CNB interventions, net foreign exchange gains totalled HRK 207m in the reference period.

Results and analysis of CNB foreign currency portfolio management in the first half of 2012

The Fed's key interest rate remained unchanged throughout the first half of 2012, ranging between 0% and 0.25%, the level at which it has stood since the end of 2008. According to forecasts, the Fed's rate could hold steady until the first half of 2015. In the first six months, the ECB's benchmark 1-week repo rate remained at 1.00%.

Figure 64 Changes in key Fed and ECB interest rates



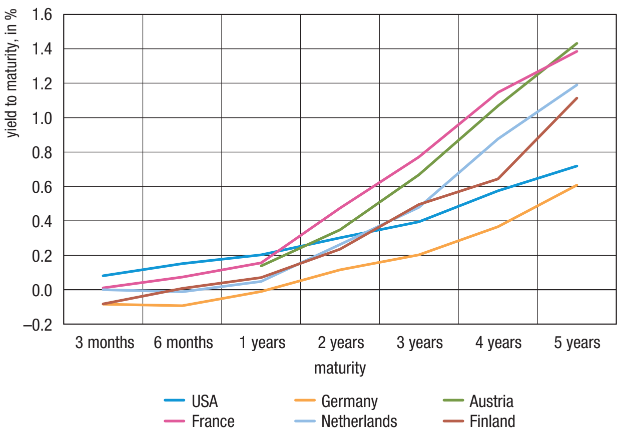
Source: Bloomberg.

Table 20 Realised income and rates of return on the CNB foreign currency portfolios
in million EUR and USD and %

Portfolio	Realised income	Annual rate of return						
	Jan.–Jun. 2012	Jan.–Jun. 2006	Jan.–Jun. 2007	Jan.–Jun. 2008	Jan.–Jun. 2009	Jan.–Jun. 2010	Jan.–Jun. 2011	Jan.–Jun. 2012
Held-for-trading euro portfolio	6.85	1.77	3.02	3.23	2.16	1.79	0.35	0.34
Held-for-trading dollar portfolio	4.56	3.59	4.98	3.67	0.07	0.96	0.62	0.38
Held-to-maturity euro portfolio	45.16	–	–	–	–	–	2.31[a]	2.31

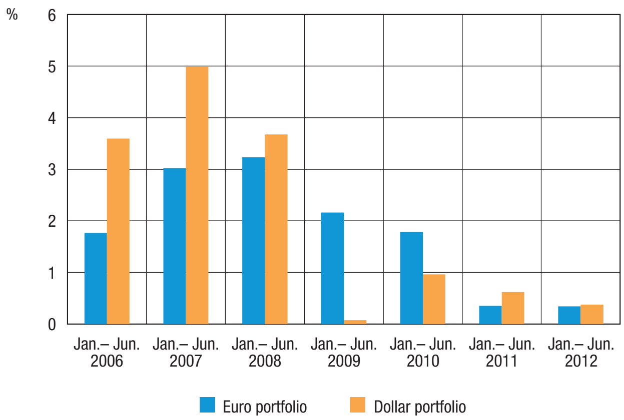
[a] Effect from 23 May 2011 to 30 June 2011.
Source: CNB.

Figure 65 Government bond yields in the USA, Germany, Austria, France, the Netherlands and Finland
as at 30 June 2012



Source: Bloomberg.

Figure 66 Rates of return on the CNB held-for-trading euro and dollar portfolios
in the first half, on annual basis



Source: CNB.

Despite the unchanged Fed and ECB benchmark rates, due to growing uncertainty in the markets, the government bond yield curves of countries considered to be the safest, such as USA, Germany, France, Austria etc., hit their historic lows, negative yields even being recorded for some issues and maturities.

The CNB's net international reserves consist of a held-for-trading portfolio (euro-denominated and dollar-denominated), a euro-denominated held-to-maturity portfolio and cash in the CNB treasury vault.

In the first six months of 2012, the average values of the euro-denominated held-for-trading portfolio and the dollar-denominated held-for-trading portfolio were EUR 3,989m and USD 2,440m respectively; the euro-denominated held-to-maturity portfolio stood at EUR 3,961m. Cash in the treasury vault amounted to EUR 199.9m.

The annual rates of return on the CNB euro-denominated and dollar-denominated held-for-trading portfolios were 0.34% and 0.38% respectively in the first half of 2012. The annual rate of return on the euro-denominated held-to-maturity portfolio was 2.31% in the reference period.

The net CNB euro portfolio generated a total income of EUR 52.01m in the first six months of 2012, while the net US dollar portfolio generated USD 4.56m in that period.

Abbreviations and symbols

Abbreviations

bn – billion
b.p. – basis points
BOP – balance of payments
c.i.f. – cost, insurance and freight
CBRD – Croatian Bank for Reconstruction and Development
CBS – Central Bureau of Statistics
CEE – Central and Eastern European
CEFTA – Central European Free Trade Agreement
CES – Croatian Employment Service
CICR – currency-induced credit risk
CIHI – Croatian Institute for Health Insurance
CPF – Croatian Privatisation Fund
CPI – consumer price index
CPIA – Croatian Pension Insurance Administration
CM – Croatian Motorways
CNB – Croatian National Bank
CR – Croatian Roads
ECB – European Central Bank
EFTA – European Free Trade Association
EMU – Economic and Monetary Union
EU – European Union
EUR – euro
excl. – excluding
f/c – foreign currency
FDI – foreign direct investment
Fed – Federal Reserve System
FINA – Financial Agency
f.o.b. – free on board
GDP – gross domestic product
GVA – gross value added
HANFA – Croatian Financial Services Supervisory Agency
HICP – harmonised index of consumer prices
HRK – kuna
incl. – including
IMF – International Monetary Fund
m – million
MIGs – main industrial groupings
MM – monthly maturity
MoF – Ministry of Finance
NCA – National Classification of Activities
n.e.c. – not elsewhere classified
NUIR – net usable international reserves
OECD – Organisation for Economic Co-Operation and Development
OG – Official Gazette
R – Republic
ROAA – return on average assets
ROAE – return on average equity
o/w – of which
PPI – producer price index
Q – quarter
RR – reserve requirement
SDR – special drawing rights
SITC – Standard International Trade Classification
USD – US dollar
VAT – value added tax
ZSE – Zagreb Stock Exchange
ZMM – Zagreb Money Market

Symbols

– – no entry
.... – data not available
0 – value is less than 0.5 of the unit of measure being used
– average
a, b, c,... – indicates a note beneath the table and figure
* – corrected data
() – incomplete or insufficiently verified data

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