Pursuant to Article 4 and Article 43, paragraph (2), item (10) of the Act on the Croatian National Bank (Official Gazette 75/2008 and 54/2013), the Governor of the Croatian National Bank hereby issues the

Recommendation to mitigate interest rate and interest rate-induced credit risk in long-term consumer loans

1 Introduction

In efforts to contribute to the stability of the financial system as a whole by protecting consumers against interest rate risk and banks against interest rate-induced credit risk, the Croatian National Bank hereby recommends to credit institutions actions to mitigate the risk associated with a possible increase in interest rates.

In the Republic of Croatia, most household loans are granted at a variable interest rate, as confirmed by the data from the Survey on interest rate variability, which the CNB conducted in mid-2016: 67% of all household loans were granted at a variable interest rate, with EURIBOR and the NRR almost equally distributed as its variable parameters (29% and 31%, respectively, of total loans). As regards housing loans, those with variable interest rates predominate even more, accounting for 82% of all loans granted, with 40% of loans linked to EURIBOR and 38% linked to the NRR.

Considerable household exposure to interest rate risk is the consequence of globally low levels of interest rates, i.e. agreed parameters[1], in particular EURIBOR, in the period when fixed margins were set based on the legal framework. In particular, in line with the Consumer Credit Act (Official Gazette 75/2009, 112/2012, 143/2013, 9/2015, 78/2015, 102/2015 and 56/2016), the variable interest rate is defined as the sum total of the agreed parameter[1] and the fixed margin. As a result, interest rate risk borne by the household sector is significant, with consumers[2] having loans with longer remaining maturities being exposed the most. In addition, the choice of the variable parameter in interest rate structure determines the transmission method of potential shocks in the domestic or foreign markets, which influence the speed, intensity and effects of the risk's materialisation (addressed in the Croatian National Bank material *Risks to the consumer in a credit relationship*).

Bearing in mind the years-long period of recession and the relatively short process of economic recovery, it is likely that current levels of household income, particularly of the households in the lower income brackets, are insufficient to withstand heavier debt servicing burdens. In such context, any interest rate increase would have an adverse feedback, both on personal consumption and economic growth, as well as bank operations (see *Analytical annex to this Recommendation*).

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[1] In accordance with the amendments to the Credit Consumer Act (Official Gazette 143/2013), the following rates may be used in setting the interest rate: EURIBOR, LIBOR, the national reference rate (NRR), yield on the T-bills of the Ministry of Finance and the average interest rate on household deposits in the respective currency.

[2] Under Article 300 of the Credit Institutions Act (Official Gazette 159/2013, 19/2015 and 102/2015), 'consumer' means any natural person who is a client of a credit institution, and who is acting for purposes outside his/her trade or profession.

Thanks, inter alia, to active CNB efforts, credit institutions have been granting an increasingly larger number of housing loans with fixed interest rates (at end-2016, such loans accounted for 22% of all newly-granted loans), and housing loans with fixed interest rates during part of the repayment period (at end-2016, such loans accounted for 47% of all newly-granted housing loans).

While the increase in the share of loans with fixed interest rates over part of the repayment period has somewhat reduced interest rate risk for consumers, the dominant segment of the total household loans portfolio has remained exposed to the risk of a significant increase in the outstanding amount of interest payments on loans.

Finally, although it is impossible to predict interest rate trends precisely in advance, the cost of interest rate fixation is relatively low bearing in mind the currently extremely low interest rates in the market.

2 Recommendation

The Croatian National Bank recommends the following to all credit institutions providing lending services to consumers in the Republic of Croatia:

1. that, in writing and as soon as possible, they offer to consumers with which they have already concluded loan agreements the possibility to change the agreement provision on a variable interest rate by agreeing on a fixed interest rate for loans with a remaining maturity equal to or longer than seven years;
2. that, when offering changes to existing loan agreements, they provide consumers with comparable repayment plans in accordance with the Decision on the effective interest rate of credit institutions and credit unions and on service contracts with consumers (Official Gazette 1/2009 and 41/2009), and results of the simulations in accordance with the Decision on the content of and the form in which consumers are provided information prior to contracting banking services (Official Gazette 2/2015 and 73/2017) by applying the terms and conditions of the existing loan agreement and the terms and conditions they offer when changing the agreement within the meaning of item (1) of this Recommendation so that consumers gain a clear insight into the offered change of their contractual obligations;
3. that, when changing existing loan agreements, they do not calculate and charge consumers any fees associated with changes to the existing loan agreements or any other fees and charges associated with changes to a contractual relationship, e.g. early loan repayment fees, and that they assess the value of the pledged real estate by using the most recent valuation they were required to make in accordance with the Decision on the Classification of placements and off-balance sheet liabilities of credit institutions (Official Gazette 41A/2014 and 28/2017);
4. that they do not charge consumers an early loan repayment fee so as to facilitate consumers' choice among the offers of credit institutions in the market;
5. that, when changing existing loan agreements, they offer consumers a fixed interest rate that is commensurate to that they currently offer or, if they do not offer loan

agreements with a fixed interest rate, that they offer consumers a fixed interest rate that does not significantly depart from the average fixed interest rate in the market[3] and that, when changing loan agreements, they do not charge an early loan repayment fee;

6. that, for the purpose of granting new consumer loans, they introduce or expand the offer of loans with fixed interest rates to increase the availability of hedges against interest rate risk for such loans and that in contracting such loans they do not charge an early loan repayment fee.

For the purpose of possible adjustments to macroprudential policy instruments and reporting to the Financial Stability Council, the Croatian National Bank shall require credit institutions to regularly submit the information on actions related to this Recommendation and shall notify the public thereof.

Zagreb, 26 September 2017

Governor

Boris Vujčić

[3] Statistical tables G2a, G2b and G2c, which are regularly updated by the CNB, provide an overview over time of movements in credit institutions' interest rates on household loans.