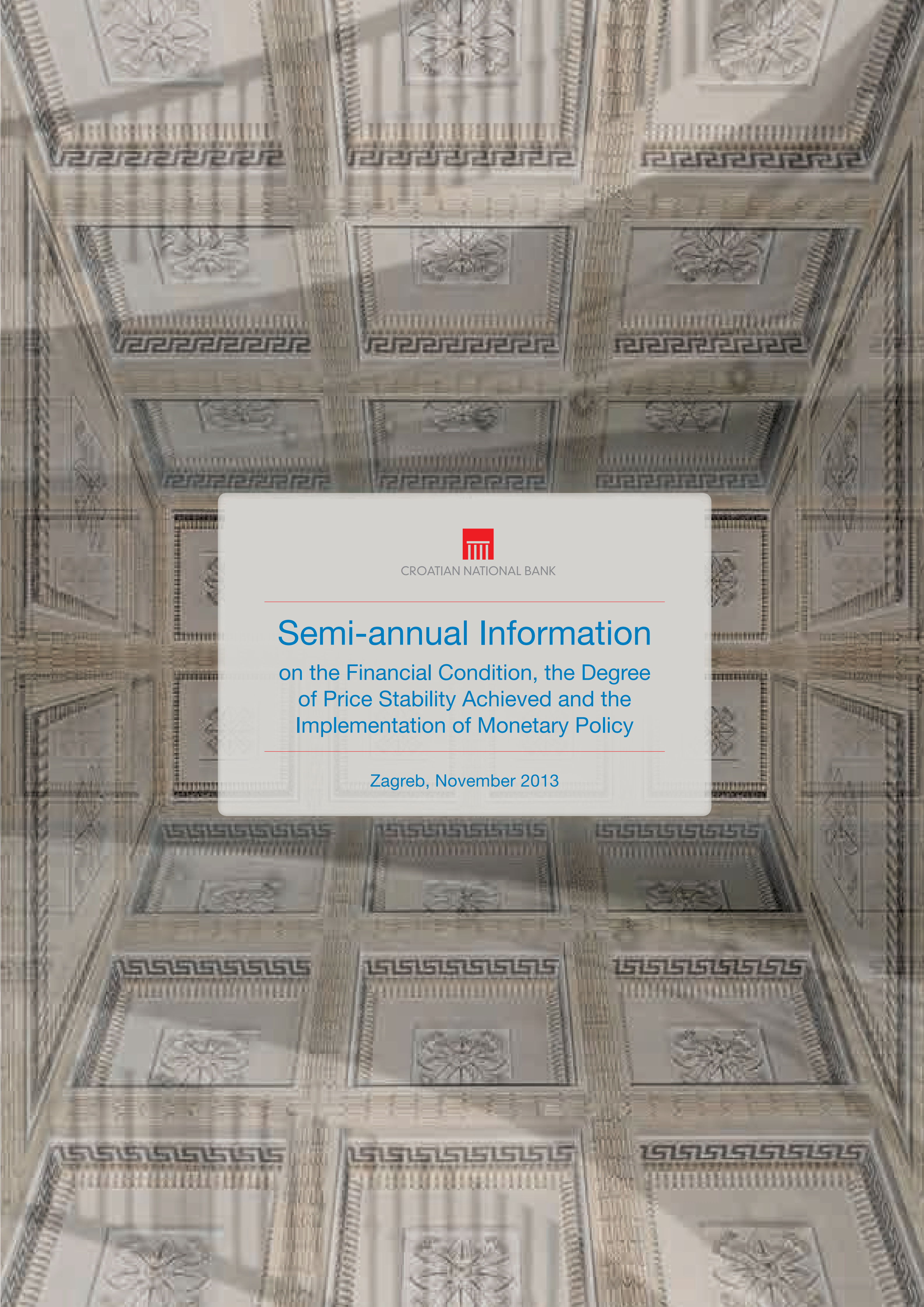

CROATIAN NATIONAL BANK

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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2013

HNB

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1 Summary

Domestic economic activity stabilised in the first half of 2013, after a years-long decline. The slight recovery in the second quarter was underpinned by more favourable developments in the eurozone and improved conditions in the international financial markets, coupled with positive one-off effects of Croatia's EU accession and the introduction of fiscal cash registers. Monetary policy continued to be focused on supporting high banking system liquidity, which confirms its expansionary nature. The domestic currency exchange rate remained stable, thereby providing the basic prerequisite for financial stability in the country. In the public finance area, the budget deficit ballooned, driven by expenditure growth, which led to a surge in public debt, which is close to 60% of GDP. Weak competitiveness continued to be one of the main barriers to any perceptible economic recovery and this should be remedied by more comprehensive structural reforms aimed at improving conditions for doing business and investment in export-oriented activities.

Real GDP dropped slightly (0.1%) in the first quarter of 2013 from the last quarter of 2012, due to a fall in exports, but rose a little in the second quarter (0.2%) as a result of growth in all aggregate demand components (according to seasonally adjusted CNB data). However, the growth figures should be taken with caution, given that the economic flows in the second quarter were strongly marked by one-off effects of the EU accession, which spurred international trade, and by the introduction of fiscal cash registers (which increased the statistically recorded turnovers in trade and in hotels and restaurants and increased government revenues).

Employment increased in the first half of 2013, halting the strong downward trend in the number of employed persons observed in the second half of 2012. The average registered unemployment rate stood at 20.3% in the first half of the year, but, due to a slight improvement in the labour market conditions, it slowed down gradually to 19.9% in June. The Labour Force Survey unemployment rate averaged 17.3% in the first half of 2013, and, as in the case of the registered rate, it improved somewhat, from 18.1% in the first to 16.5% in the second quarter.

Consumer price inflation slowed down significantly over the first half of 2013, from 5.2% in January to 2.0% in June. This was primarily due to a favourable base effect, but also the result of the easing of imported inflationary pressures and absence of any domestic inflationary pressures from the demand and cost sides. Most inflation components (except processed food products) contributed to this slowdown, especially energy.

The current account balance continued to improve during the first half of 2013, mainly due to the narrowing of the factor income account deficit. The services account balance also improved, thanks to tourism revenues, as did the current transfers account balance. By contrast, the goods trade deficit rose due to a fall in goods exports concomitant with stagnation in imports.

High risk appetite and strong liquidity in the international financial markets at end 2012 and in the first half of 2013 helped improve the financing conditions for the government and parent banks in the international marked compared with the first half of 2012. Coupled with the CNB policy of supporting high domestic monetary system liquidity, this resulted in lower domestic borrowing costs. Interest rates on the MoF T-bills fell to their historical lows, whereas non-financial enterprises recorded lower interest rates on short-term and, to a lesser extent, long-term bank loans. The household financing terms remained unchanged. Despite an increase in total corporate financing, there was no significant improvement in lending activity, due to weak demand, tightened lending conditions, the rise in non-performing loans and the delayed recovery of the domestic economy. Weak demand for loans and strong risk aversion reduced the effects of the expansionary monetary policy aimed at maintaining high liquidity of the monetary system, followed by the CNB throughout the period after the onset of the crisis.

In the first half of 2013, net foreign capital inflow was close to its level in the same period last year. There were changes in the inflow structure, with the stronger inflows of debt capital offsetting a fall in equity investments in Croatia. The bulk of the net debt capital inflows related to the government and credit institutions, while new foreign equity investments in Croatia remained modest. Gross external debt increased by EUR 1.2bn in the first half of 2013 (if cross-currency changes and other adjustments are excluded), and stood at EUR 46.2bn or 104.9% of GDP (recorded in the last four quarters) at the end of June.

In an environment of strong foreign capital inflows and reduced current account deficit, the CNB made net foreign exchange purchases, thereby creating net kuna liquidity and further increasing excess liquidity in the banking system, which only confirmed the expansion-oriented monetary policy of the central bank. The kuna/euro nominal exchange rate remained stable, thereby providing the basic prerequisite for the financial stability in the country. The gradual increase in gross and net usable international reserves continued in the observed period.

Total international reserves of the CNB picked up by EUR 784.6m in the first half of the year, reaching EUR 12.0bn at end-June, and net international reserves increased by EUR 264.8m to EUR 10.5bn. Total revenues derived from the CNB's net euro portfolio and net US dollar held-for-trading portfolio in this period were EUR 42.0m and USD 0.9m respectively. International reserves were managed in the first six months of 2013 against a background of low benchmark interest rates and rising uncertainty in financial markets, which was why yields on government securities of developed countries, prevailing in the structure of the CNB's international reserves, remained extremely low. In view of the principles of liquidity and safety followed by the central bank in international reserves management, due to heightened uncertainty in financial markets, strict rules on investment in certain countries and financial institutions remained in effect.

The effects of adverse movements in the economic environment on the banking system in the first half of 2013 were reflected in weak lending activity and further credit risk materialisation. The long-lasting recession led to a sharp fall in banks' profits and undermined the profitability of their operations.

In the first half of 2013, banks generated HRK 1.3bn in profits (from continuing operations, before tax), which was 40.8% less than the profits derived in the first half of 2012.

ROAA and ROAE dropped to 0.6% and 3.5% respectively. The fall in profits was primarily due to lower interest income from loans, particularly corporate loans, and higher expenses on provisions for credit portfolio losses. The increase in these expenses was due to loan collection problems and growth in fully irrecoverable loans, as well as greater caution in the assumption of risks which led to a slight rise in loans (by 2.0% effectively) and an increase in less risky placements. An additional cause of the slight change in loans was the absence of any major growth in loans granted by large banks, mostly due to household deleveraging. The trend toward household deleveraging continued for the fifth consecutive year, with a fall in home loans being the main contributor to debt reduction in the observed period. A minor increase in total loans mainly related to corporate loans, predominantly loans for working capital and syndicated loans, and loans to government units. The absence of any very strong recovery of lending activities and continued unfavourable economic developments led to a further deterioration in loan quality indicators. Hence, the share of loans classified into B and C risk categories reached 15.1% at the end of June 2013. The share of B and C category loans in the corporate sector rose markedly (to 26.9%), mainly due to growth in B and C category loans in the trade and construction activities.

Strong bank deleveraging observed for most of 2012 stopped in the first half of 2013, resulting in a small increase in assets (by 1.3% effectively). The growth in the sources of financing was mostly based on the growth of non-resident deposits, but the sources from majority foreign owners continued to decline. Nevertheless, they still accounted for a significant 16.8% of the total sources of financing. Domestic sources of financing also declined, as a result of moderate bank deleveraging on the domestic financial market. As regards domestic sources of financing, household deposits remained stable sources of bank financing, despite their sharp slowdown, to only 1.0% effectively, at the semi-annual level. The total balance sheet growth was based on an increase in kuna asset items, which suggested a slight change in the banks' balance sheet currency structure.

The payment of the major part of the profit made in the previous year and a part of profits from the previous years was the main cause of a minor decline in bank capital. Together with the concomitant slight decrease in total capital requirements, this led to a negligible fall in the capital adequacy ratio, to 20.8%. The high capital adequacy and balance sheet capital-to-liabilities ratios continued to be the signs of a satisfactory level and quality of banks' capital.

Consolidated general government revenues decreased by 0.7% annually in the first half of 2013, mainly due to a fall in revenues from profit tax and social contributions, while VAT revenues made the largest positive contribution to total revenue movements. Consolidated general government expenditures, including the acquisition of non-financial assets, increased by 8.5% from last year, mostly due to the debt settlement in the health sector. As a result of the slight decline in revenues and relatively strong growth of expenditures, the overall fiscal deficit picked up by HRK 5.6bn annually, standing at HRK 12.6bn in the first six months. Hence, total fiscal deficit almost reached the amount planned for the whole of 2013. As the funds necessary for deficit financing were raised through new borrowing, pubic debt continued to surge.

2 Global developments

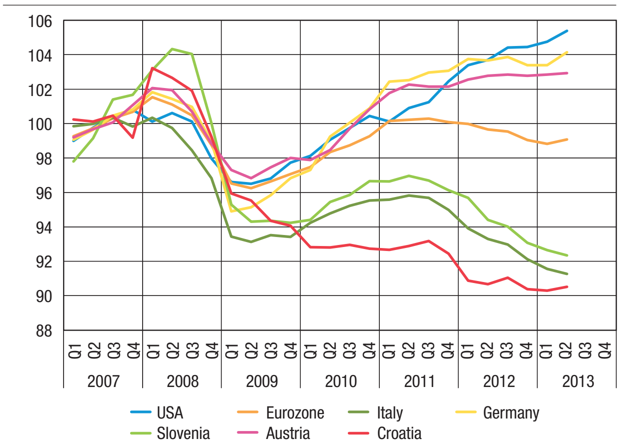
Global economic growth accelerated slightly in the first half of 2013 thanks to favourable movements in developed economies, while the economic slowdown in emerging market economies continued. After six quarters of decline, real economic activity in the eurozone expanded in the first half of the year. Real GDP grew at a much faster pace in the US and Japan, due to the extremely expansionary policies pursued by these countries. China and India recorded further economic slowdown, as a result of unfavourable trends in both global and domestic demand.

The decline in real economic activity in the eurozone recorded in the first quarter (0.2%) was followed by a 0.3% increase in real GDP during the next quarter, the first quarterly increase after six consecutive quarters of decline. Broken down by aggregate demand components, personal and government consumption and net exports made positive contributions to GDP outturns, while the contribution of gross fixed capital formation was negative. Among the EU member states, Germany and France were the largest contributors to GDP growth in the eurozone during the second quarter, while Italy and Spain had the strongest negative influence on economic growth dynamics. As regards peripheral eurozone countries, Greece and Spain continued to face recession and deterioration in the labour market conditions during the second quarter, unlike Ireland and Portugal, which experienced economic expansion and a further decrease in unemployment rate.

Economic movements in the USA and Japan during the first half of the year made a strong positive contribution to total global economic growth dynamics. The acceleration of economic activity in the USA was primarily due to growth in personal consumption and private investment. Government consumption contributed negatively to GDP growth, as a result of enforcement of the regulations repealing part of the previously granted fiscal incentives. In contrast to fiscal policy, monetary policy continued to spur economic recovery, but announced a possible slowdown in monetary expansion towards year-end. Japanese authorities also opted for unconventional monetary policies, aimed at, among other things, removing persistent deflationary pressures on the economy. Monetary easing was part of a comprehensive recovery programme adopted at end-2012, a combination of fiscal incentives, structural reforms and monetary expansion. According to indicators for the first half of the year, this mix of economic policy measures was effective. Capital markets saw a strong upturn, with deflationary pressures easing off and goods and services exports going up, despite weak global demand, due to strong depreciation of the yen against the main world currencies.

Major emerging market economies continued to record high economic growth rates, but with a noticeable downward trend. Economic slowdown in China continued in the first six months of 2013, mainly due to weak global demand, which, combined with domestic currency appreciation, adversely affected the country's export outturn. From the outbreak of the financial crisis, the Chinese economy made remarkable progress in external adjustment, which led to a marked decrease in the current account surplus. However, given an ever-increasing internal imbalance in the economy, especially as regards credit and real estate market expansion, the government announced reforms with a view to balancing growth and mitigating the risks. Economic slowdown in India, recorded for seven consecutive quarters, was mainly due to gradual weakening of domestic demand. As the announcement of possible changes in the US monetary policy led to a strong portfolio investments outflow and a depreciation of the Indian rupee, the Indian central bank decided to halt the gradual monetary expansion carried out over the last year.

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



Sources: Eurostat and CNB.

2.1 Croatia's main trading partners

Among Croatia's main trading partners in the eurozone, Austria and Germany recorded economic growth in the first half of 2013, while Slovenia and Italy saw a further decline in their respective economic activities. It is noteworthy, however, that the quarterly rate of downturn in Slovenia and Italy decreased from the previous two quarters, suggesting a slowdown in adverse economic movements. The negative trends recorded in Croatia's exports to the above mentioned countries (except Germany) since the beginning of the year weakened as well.

After stagnation early in the year, the German economy grew at a real rate of 0.7% in the second quarter from the previous quarter, as shown by marked growth in almost all domestic demand components. Exports grew strongly as well, but, given the concomitant increase in imports at an almost equal rate, the positive impact of the external sector on GDP dynamics failed to materialise.

In Austria, real economic activity strengthened slightly during the first half of the year, with the largest positive contributions coming from government consumption and net exports, while the effects of gross fixed capital formation were negative. Despite further strong growth in employment, personal consumption continued to stagnate, probably due to weak growth in real disposable income. The positive contribution of net exports to growth was weaker in the second quarter than in the first three months, due to a slower decline in imports.

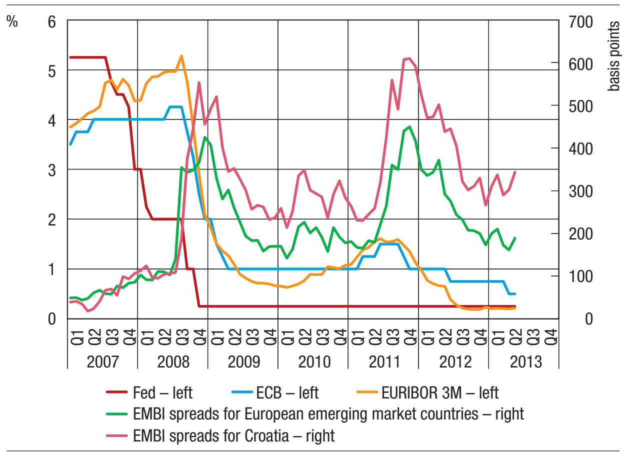
Economic activity in Italy declined in real terms in the second quarter of 2013, for the eighth consecutive quarter, by 0.2% from the previous three-month period. A continuation of unfavourable economic trends in the first semi-annual period was due equally to a slowdown in foreign trade and a weakening of domestic demand. Household consumption was adversely affected by movements in disposable income and a further deterioration in the labour market. Credit activity was weak as well.

Economic activity in Slovenia continued to decline in the first half of 2013, but at a slower pace, as suggested by some indicators. Broken down by aggregate demand components, the economic downturn was due to a decrease in personal and government consumption. The downturn was softened by an increase in gross fixed capital formation in the second quarter, the first such increase after nine consecutive quarters of decline.

In Serbia, economic recovery from the last quarter of 2013 continued in the first half of the year, at a real annual rate of 1.4%. The key growth generators were net exports, while personal and government consumption contributed negatively to growth. Despite the worsening prospects for recovery in Croatia's main trading partners, net exports could continue to be the main driving force of growth in the remainder of the year, while domestic demand could be limited, in an environment of low real income and fiscal consolidation. Economic activity acceleration in the first half of the year was strongly influenced by an increase in output in the automotive industry caused by major foreign direct investments in this sector.

As shown by industrial production and foreign trade indicators, real economic activity in Bosnia and Herzegovina strengthened in the second half of 2013. However, the total volume of industrial production index, which had been high in April, declined in the following two months. After a review of the Stand-by Arrangement in May, the IMF Mission concluded that the program was being implemented in a satisfactory manner, as suggested by the timely achievement of fiscal targets and signs of a gradual economic recovery, which provided a basis for the IMF real GDP growth expectations for the whole of 2013.

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



Source: Blomberg.

however, that these transactions could be reduced considerably towards the end of the year, as a result of economic recovery, and even cancelled completely by mid-2014.

The financing terms for European emerging market economies generally improved during the first half of 2013. A fall in global risk aversion early in the year led to a further decline in yield spreads on the bonds of European emerging market economies. This trend was reversed in February on the back of widening political conflicts in Italy and uncertainty about resolving the financial situation in Cyprus. Relieved uncertainties in the financial markets led to a new decline in the yield spread in April and May. In June, however, the spread rose on account of market expectations that the Fed would start reducing the volume of its monthly securities purchases, and ranged around 195 basis points at the end of the month, which was still considerably below its level in the same period in 2012. While the risk perception regarding Croatia also deteriorated from the same period in 2012, the yield spread remained above the average for comparable European countries, ranging around 350 basis points.

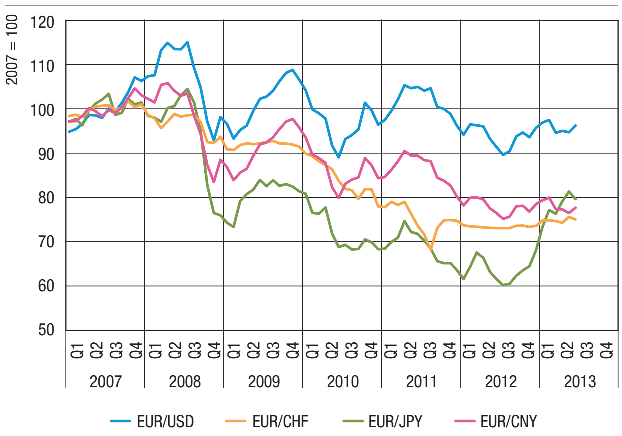
2.2 Benchmark interest rate trends

Improved conditions in foreign financial markets and stable cyclical economic indicators, helped maintain euro benchmark interest rates at low levels in early 2013. Against this background, market interest rates in the eurozone remained relatively stable, with the 3-month EURIBOR rate hovering around an extreme low of 0.2% in the first six months of 2013, the level it had reached at the beginning of the fourth quarter of 2012. However, in early May, spurred by low inflationary pressures and concern over the absence of any economic recovery in the eurozone countries, the ECB cut its key interest rate by 25 basis points, to 0.75% and announced the possibility of introducing negative interest rates on overnight deposits and new non-standard measures to encourage crediting. The Fed kept its key interest rate at its historical lows announcing also that it would stick to this policy as long as the unemployment rate exceeded 6.5%. The Fed continued its agency mortgage bonds and long-term securities purchase programme, announcing,

2.3 Exchange rates and price developments

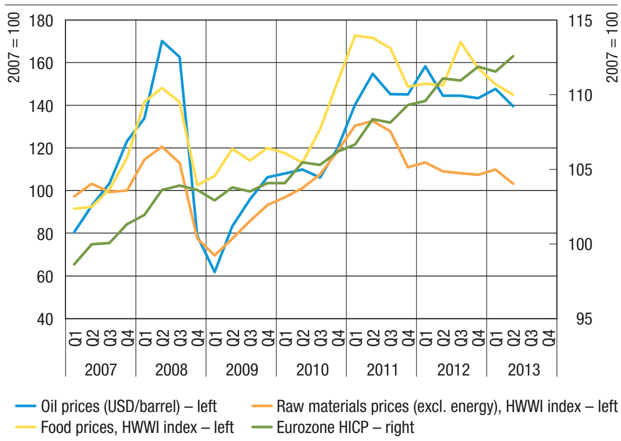
In the first six months of 2013, the US dollar depreciated against the euro by 2.2% relative to its average value in 2012. The Swiss franc also depreciated against the euro at an almost equal rate in this period. Having depreciated against the euro early in 2013, as a result of a boost in investor optimism in the European markets, the US dollar started to appreciate in February on the back of growing concern over the political situation in Italy related to parliamentary elections, the granting of financial assistance to Cyprus and the manner of dealing with the country's banking sector difficulties. Despite the brief halt to the US dollar appreciation trend in April, the ECB's decisions in May to reduce its key interest rate facilitated further strengthening of the US currency. After that, depreciation pressures on the US dollar predominated in the first half of June, which was caused, among other things, by market expectations that the Fed could tone down its monetary easing programme. Having depreciated against the euro early in the

Figure 3 Exchange rates of individual currencies



Note: A growth in the index denotes a depreciation of a currency against the euro.
Source: Eurostat.

Figure 4 Prices



Sources: Eurostat, Bloomberg and HWWI.

year, the Swiss franc strengthened for most of the period from the beginning of February to the end of April. In May, however, it depreciated to an average of EUR/CHF 1.24 and remained at that level in June. This was due to reduced demand for safe investments, in an environment of eased concern about the financial stability and the resolution of the eurozone debt crisis, as well as expectations about a possible increase in the exchange rate floor of EUR/CHF 1.20 and the introduction of a negative interest rate on banks' liquidity surpluses with the Swiss central bank.

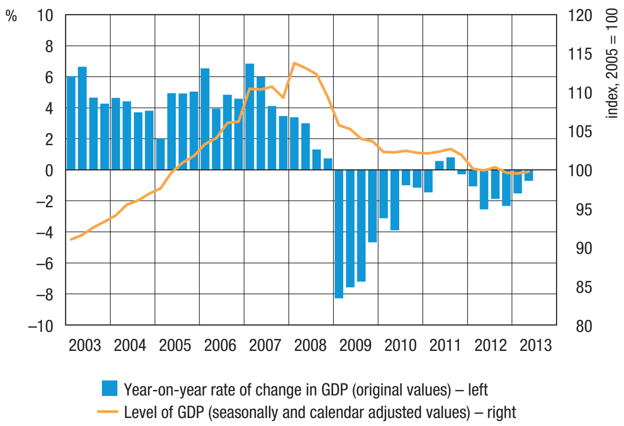
Crude oil prices, which rose in the first two months of the current year, declined gradually over the first half of the year and stabilised afterwards. The increase early in the year was due to growing optimism regarding economic developments in the eurozone and improved economic outlooks for the US and China, so that the price reached 110 US dollars per barrel in mid-February. This was followed by a decline in oil prices against the background of weak economic performance indicators in major world economies and expectations of a slowdown in global demand coupled with stronger supply of this energy product. As a result, the price per barrel dropped to USD 97 in mid-April. Towards the end of April, crude oil prices went up but then stabilised at about USD 103 per barrel in May and June.

The prices of raw materials excluding energy increased during the first two months of 2013 and then started to decline. A sizeable price growth during the first two months of 2013 was recorded in iron ore, and the prices of agricultural raw materials and textile also went up. The remainder of the first half of the year mainly saw a fall in the prices of raw materials excluding energy. Specifically, in the following four months, the prices of food products declined further and those of ferrous metals also dropped markedly, largely due to an economic slowdown in China, which accounts for over 40% of the world consumption of metals. The HWWI index of raw material prices (excluding energy, in USD) thus fell to a level last recorded in mid-2010.

3 Aggregate demand and supply

After a fall in 2012, real economic activity stabilised gradually during the first two quarters of 2013. Real GDP, seasonally adjusted, declined slightly in the first quarter (by 0.1%), due to a slump in exports from the previous quarter. In the second quarter, it rose by 0.2%, as a result of growth in all aggregate demand components. The largest contribution to GDP growth came from personal consumption, while net exports contributed negatively to the economic activity, due to stronger growth in imports. The slight growth in GDP in the second quarter should be taken with caution, given the one-off effects of Croatia's EU accession and the introduction of fiscal cash registers. A few months before the accession, foreign trade intensified on account of forthcoming customs policy adjustments, which provided a strong impetus to both exports and imports. Moreover, the introduction of fiscal cash registers led to sizeable growth in reported revenues in certain activities, which in turn resulted in an increase in statistically recorded personal consumption, but it also made it difficult to assess current economic activity dynamics.

Figure 5 Gross domestic product
real values



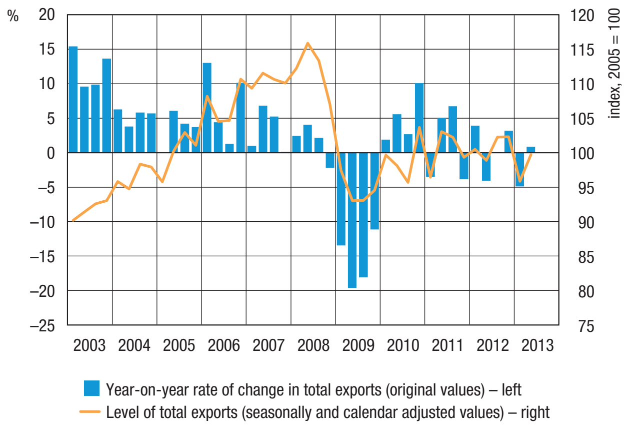
Source: CBS data seasonally adjusted by the CNB.

3.1 Aggregate demand

Seasonally adjusted CNB data suggest a decline in goods and services exports by 6.3% in the first quarter from the previous three-month period. This was due to a decrease in goods exports, while services exports increased in nominal terms at the annual level. If goods exports are broken down into their separate components, a particularly sharp decline can be observed in the export of other transportation equipment (notably ships), food products, mining and quarrying products and electrical machinery, apparatus and appliances. Goods and services exports increased by 4.1% in the second quarter, but this was partly due to the base effect observed in the first quarter. Broken down by main industrial groupings, the exports of non-durable consumer goods and capital goods increased while the exports of other product groups continued to decline. The changes in the customs regime expected upon the accession of Croatia to the EU prompted exporters to sell more goods in CEFTA countries in the pre-accession period, mainly relating to food products. The exports of capital goods increased, mostly due to stronger exports of other transportation equipment at the quarterly level. The growth in total exports in the second quarter was also due to the exports of services, which were up 2.4% at the quarterly level, reflecting good performance in tourism. Tourist nights and arrivals rose markedly (4.3% and 5.2% respectively); domestic tourist nights decreased and the nights stayed by foreign tourists increased.

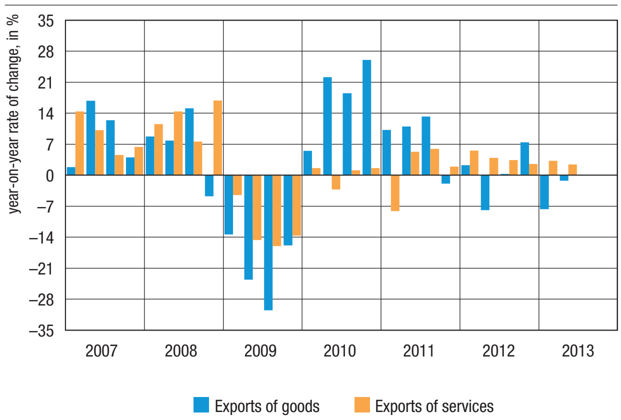
Despite the downward trend in real disposable income and consumer credit, personal consumption increased at the quarterly level (according to seasonally adjusted CNB data) in the

Figure 6 Exports of goods and services
real values



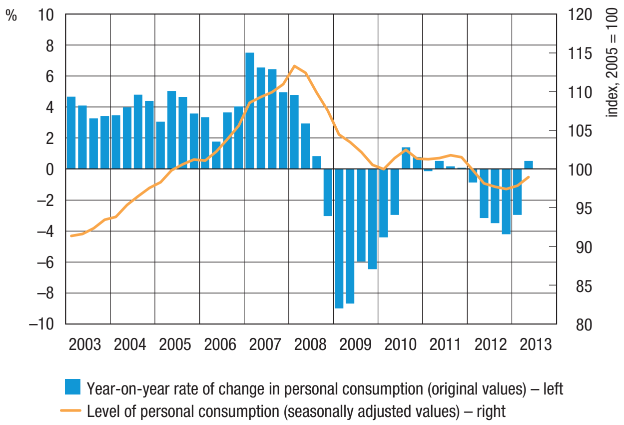
Source: CBS data seasonally adjusted by the CNB.

Figure 7 Nominal exports of goods and services



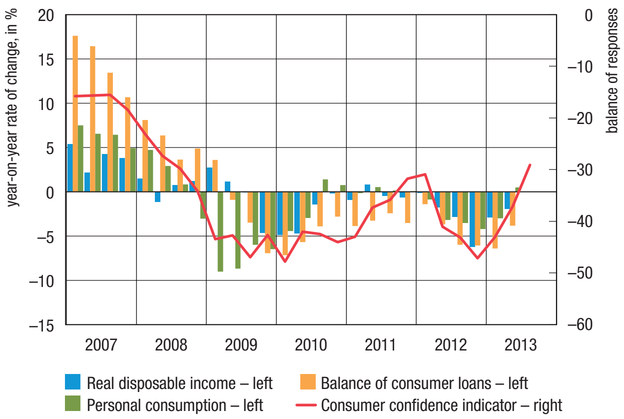
Source: CNB.

Figure 8 Personal consumption
real values



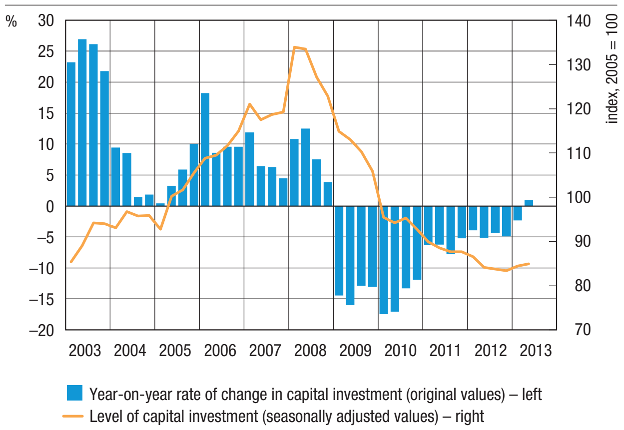
Source: CBS data seasonally adjusted by the CNB.

Figure 9 Determinants of personal consumption



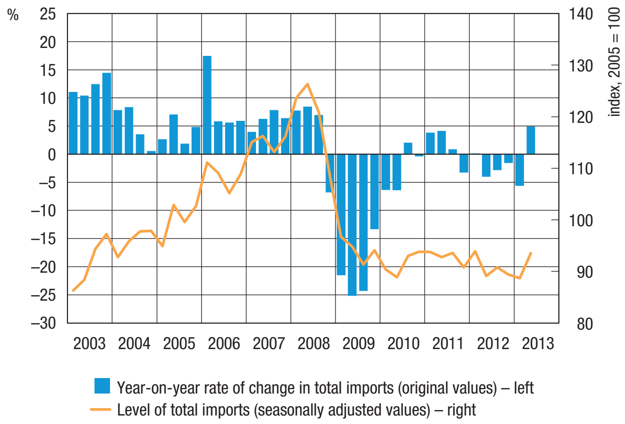
Note: The values of the consumer confidence indicator in a month are calculated as averages of monthly data.
Sources: CBS, Ipsos Puls and CNB.

Figure 10 Gross fixed capital formation
real values



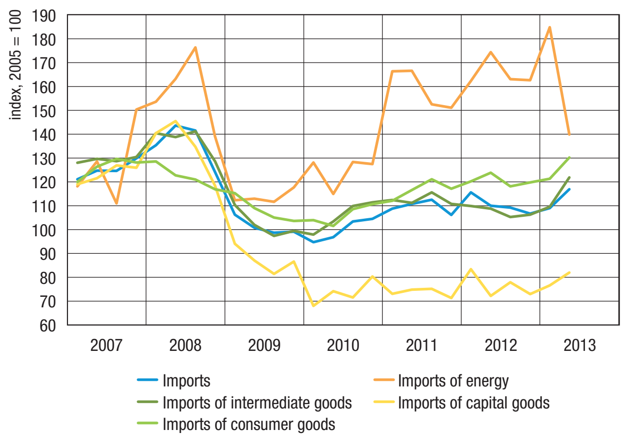
Source: CBS data seasonally adjusted by the CNB.

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

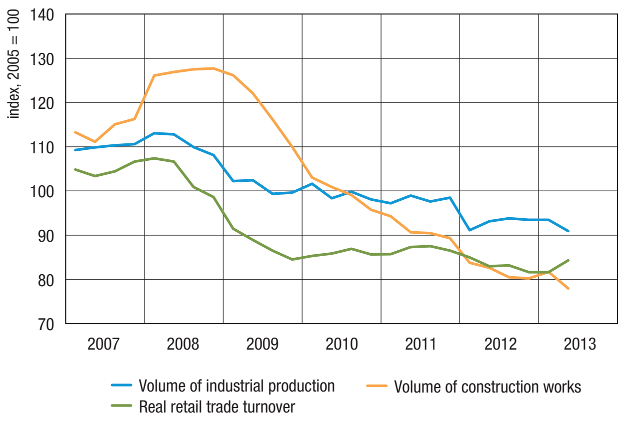


Source: CBS data seasonally adjusted by the CNB.

first two quarters of 2013. These movements, particularly observed in the second quarter, lead to the conclusion that the increase in the statistically recorded consumption was due to a reduction of the shadow economy in certain activities after the introduction of fiscal cash registers. The consumer confidence index has grown since the beginning of the year, reflecting expected improvements in the financial position of households, employment and, to a lesser extent, the economic situation in Croatia. However, the consumer confidence index fell markedly below its long-term value, suggesting that households' expectations continue to be negative.

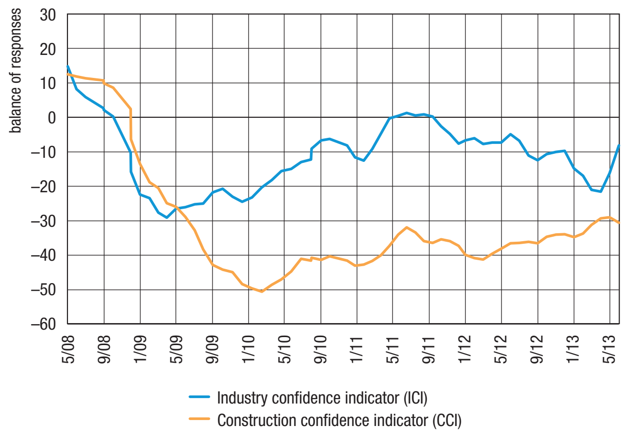
Investment activity strengthened by 1.2% in the first quarter (seasonally adjusted by the CNB). Investments at the state budget level and by Croatian Roads increased markedly, as did civil engineering works. Capital investment growth continued into the second quarter. Sizeable growth in capital goods imports suggests an increase in the import component of investment growth, while the volume of industrial production of capital products continued to decline. This primarily related to a sharp one-off increase in the imports of road vehicles and

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.

capital equipment, by 40.3% and 24.2% respectively from the previous quarter, although the increase was mainly observed in the imports of photovoltaic products as a consequence of Croatia's EU accession. The data on completed construction works show no signs of any major recovery, given that the works on buildings decreased markedly in the second quarter from the first quarter of 2013. By contrast, the government's investment activity intensified, especially in road construction.

Government consumption went up 1.2% in the first quarter of 2013 and the trend continued in the second quarter, when it grew by 0.7%, according to seasonally adjusted CNB data. The increase in government consumption was primarily due to the increased use of goods and services, while a slight improvement was also observed in employment in the public sector. Nevertheless, employee compensation decreased in nominal terms, due to a 3% decline in gross wages in the government sector observed since early March this year.

A 0.8% decline in the imports of goods and services during the first quarter (seasonally adjusted by the CNB), spurred by a fall in disposable income and an economic downturn, was followed by a surge in imports (5.5%) in the second quarter, as a result of the one-off effects of changes in excise taxes and international trading terms caused by the accession of Croatia to the EU and growth in all aggregate demand components. Despite the decline in goods and services imports, goods imports increased in all the main industrial groupings in the first quarter, except in non-durable consumer goods. As already mentioned, the imports of road vehicles and capital equipment rose markedly in the second quarter. Broken down by main industrial groupings, the largest increase was recorded in the imports of intermediate and capital products and non-durable consumer goods. Energy imports declined sharply due to increased domestic production of electricity. According to nominal data, the imports of services also fell in this period.

3.2 Aggregate supply

Gross value added in the Croatian economy followed the trend in aggregate demand during the first half of 2013. Seasonally adjusted GVA stagnated in the first three months of 2013 from the last quarter of 2012. Economic activity declined in manufacturing, financial and insurance activities, real estate transactions and agriculture, while it strengthened in other NCEA divisions.

GVA rose by 0.3% in the second quarter, primarily as a result of growth in trade, transportation, accommodation and food service activities, a slight increase in public administration, defence, health protection, social welfare and education activities and even slower growth in agriculture. Activity in manufacturing continued to decline, whereas in construction, the several-years downward trend continued, after a negligible increase of 0.1% in the first three months of 2013, Business optimism indexes in industry and construction rose slightly from end-2012.

4 Labour market

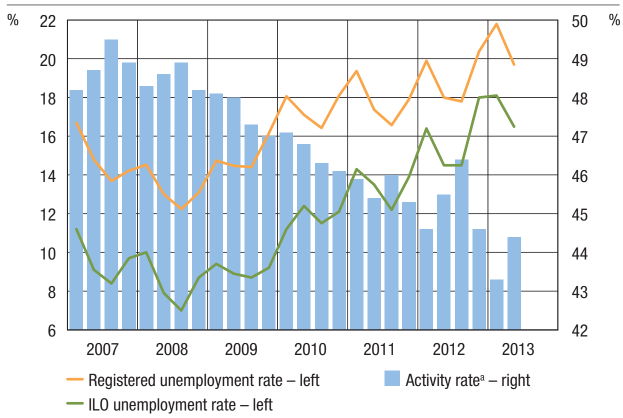
Employment increased in the first half of 2013 (according to seasonally adjusted CPIA data), halting the strong downward trend in the number of employed persons observed in the second half of 2012. Favourable movements were temporarily suspended only in April, when the number of employed persons decreased at the monthly level. Broken down by NCEA activities, the number of employed persons rose in the services sector and public administration, while it declined further in industry and construction. The favourable labour market movements were stopped in July and August, so that the number of employed persons slowed down abruptly in July and fell markedly at the monthly level in August.

Having grown rapidly throughout 2012, unemployment declined slightly over the first six months of 2013 (according to seasonally adjusted CES data), and a further decrease in the number of unemployed persons was recorded in July and August. The average number of unemployed persons was 344 thousand in the first eight months (original data), up about 30 thousand from the same period in 2012. As with employment, negative movements were observed only in April, when the number of unemployed persons shot up. The average administrative unemployment rate stood at 20.3% in the first half of the year, but, due to a slight improvement in the labour market conditions, it slowed down gradually to 19.9% in June, and further to 19.7% in July and August. The Labour Force Survey unemployment rate was 18.1% in the first three months of 2012, but it declined to 16.5% during the second quarter.

Nominal gross and net wages rose in the first half of the year (according to seasonally adjusted CBS data), but decreased slightly during July and August. Real wages picked up slightly over the first six months, but fell again in July and August, which was consistent with the decline in nominal wages and the rise in the level of prices.

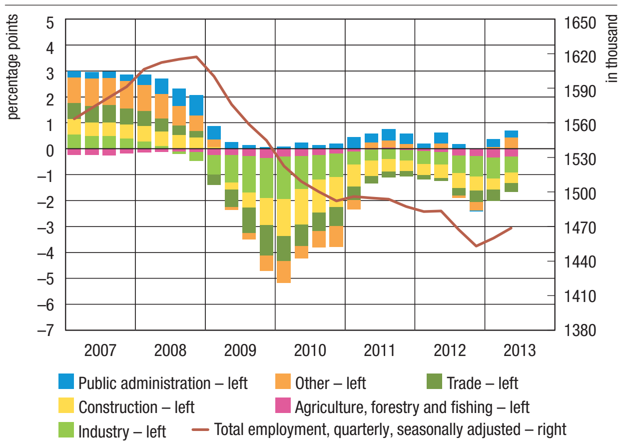
Nominal unit labour costs went up during the first quarter, primarily due to a surge in nominal compensation concomitant with labour productivity stagnation. In the second quarter, nominal unit labour costs declined slightly, as a result of a somewhat sharper fall in labour costs than in labour productivity during that period, but remained above the average level recorded in the second half of 2012. Real unit labour costs also increased in the first half of 2013.

Figure 16 Unemployment and activity rates



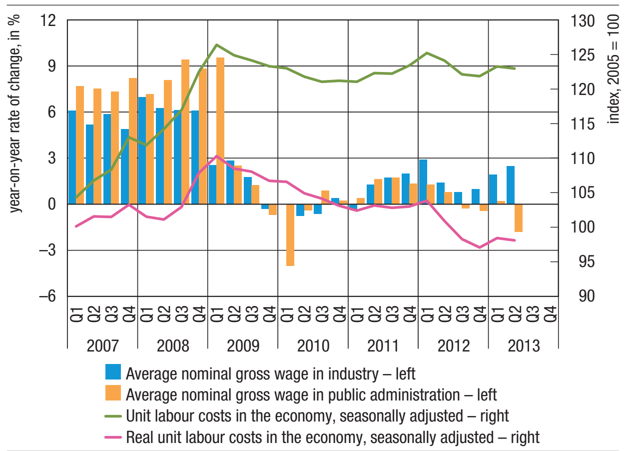
[a] The labour force as a percentage of working age population (15+).
Note: The Labour Force Survey is published quarterly since the beginning of 2007.
Sources: CBS and CES.

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

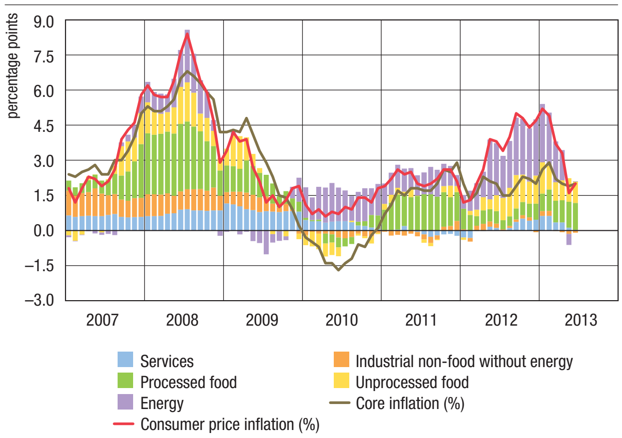
Consumer price inflation slowed down markedly in the first half of 2013. This was primarily due to a favourable base effect[1], but was also the result of the easing of imported inflationary pressures and absence of any domestic inflationary pressures from the demand and cost sides. A high annual inflation rate of 5.2% was recorded in January 2013, and its increase from December 2012 was largely due to administrative decisions (the repeal of the zero VAT rate, and increases in the prices of water and railway services). Subsequently, in consequence, the inflation rate slowed down and the annual rate of change decreased by 3.2 percentage points, standing at 2.0% in June. Most inflation components (excluding processed food products), contributed to this result, especially energy (its contribution to inflation decreased by 2.5 percentage points). The annual rate of change in energy prices decreased from 13.0% in January to 0.1% in June, thanks to the favourable base effect and, partly, to the fall in the prices of refined petroleum products and gas. Inflationary pressures coming from the global crude oil markets eased from mid-February, when the crude oil price exceeded USD 119 per barrel, but stabilised at about USD 103 in the second quarter. Imported inflationary pressures slackened, among other things due to a sharp decrease in metal prices; the slight downward trend in the prices of food raw materials continued. The fall in crude oil prices was due to expectations of slower growth in global demand and a concomitant rise in the supply of this energy product, while the fall in the price of non-ferrous metals was mainly attributable to an economic slowdown in China, a country accounting for over 40% of the world consumption of metals.

A slowdown in the annual growth of energy prices led to a strong deceleration of domestic industrial producer prices, from 5.4% in January to 0.9% in June. Core inflation (which excludes energy prices and other administrative prices, as well as agricultural product prices) declined at a slower pace, from 2.6% in January to 2.0% in June.

The absence of domestic inflationary pressures, caused by weak domestic demand, adverse labour market conditions and a slight fall in unit labour costs, was most reflected in the movements of industrial product prices (excluding those of food and energy), which dropped by 0.4% from the same period last year, and services prices, which rose by as little as 1% annually in June. The reduction in the VAT rate on catering services from 25% to 10% early in the year did not lead to any decrease in their prices in January.

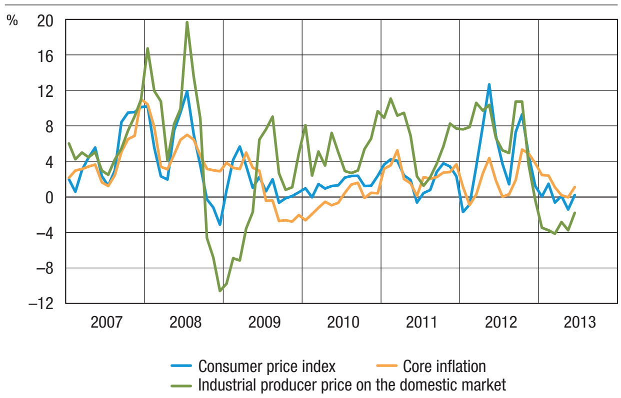
Food products contributed the most to the annual inflation

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



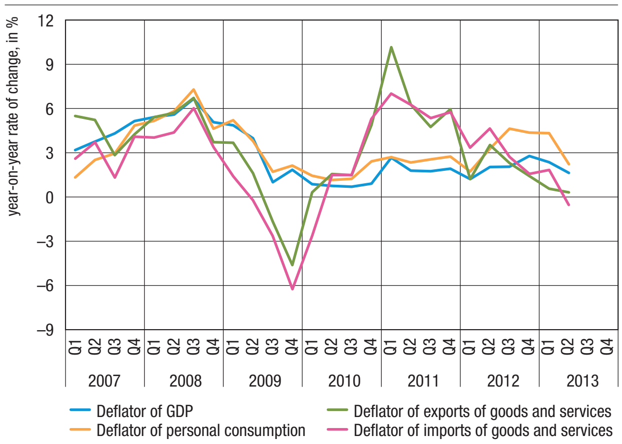
Sources: CBS and CNB calculations.

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



[a] Core inflation excludes agricultural product prices and administrative prices.
Note: 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.

1 This was caused by marked price growth in the same period last year, due to the increase in the general VAT rate and in the locally regulated prices (e.g. water supply, etc.) in March 2012, the rise in refined petroleum product prices over the first four months of 2012 and a surge in electricity and natural gas prices in May 2012.

growth in June. Despite the slowdown in the annual rate of change in unprocessed food products during the first half of 2013, this rate remained relatively high in June (6.9%), due to a fall in meat prices. Due to an unfavourable base effect related to the prices of processed food products[2] (including alcohol and tobacco), their contribution to inflation increased by 0.4 percentage points in June from January, and the annual rate of change in these prices reached 5.5%. This was due, among other things, to a substantial increase in the prices of milk and dairy products in May and a rise in the prices of tobacco products caused by higher excise taxes in effect since end-2012.

Having mounted in early 2013, imported inflationary pressures eased again, as suggested by the fall in the annual rate of change in the implicit deflator of imports of goods and services. The decline in import prices was largely due to the above mentioned drop in the world prices of crude oil and other raw materials (notably metals and food raw materials), recorded in the second quarter. Thanks to the relatively insignificant decrease in the annual rate of change in the implicit deflator of imports of goods and services, trade conditions improved in the second quarter of 2013.

2 The prices of these products dropped in March 2012, as a result of a lower VAT on certain food products.

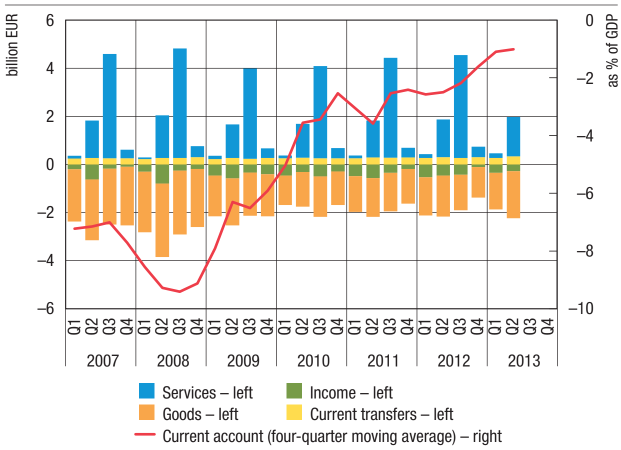
6 Foreign trade and competitiveness

The current account balance continued to improve in the first half of 2013. It was EUR 0.3bn higher than in the first half of 2012, while its relative annual indicator went up from –1.0% of GDP to 0.8% of GDP (cumulative value in the last four quarters). The main contributor to the improvement in the overall balance was the fall in the factor income deficit brought about by lower direct investment expenditures (profit of foreign owners of domestic enterprises and banks). The balance in the international trade in services also improved, largely due to the rise in tourism revenues. By contrast, the goods deficit widened from the first half of 2012, due exclusively to the drop in exports of goods, with goods imports holding steady on an annual level. The balance in the current transfers account improved marginally owing to the increase in net income of households.

The drop in direct investment expenditures, which largely determined the developments in the factor income account in the first half of the year, mostly related to financial intermediation activity, which recorded a sharp annual fall in profit. Business performance deteriorated also in many manufacturing activities, with the exception of oil production and the chemical industry, which also added to the fall in total factor expenditures. To a lesser extent, the drop in the total deficit was also due to lower interest expenses on foreign borrowing. This refers to interest expenses of banks, which intensified their deleveraging efforts in the observed period, and of enterprises, which refinanced their due foreign liabilities under more favourable terms and thus cut their interest expenses. By contrast, interest expenses of the central government rose sharply due to substantial foreign borrowings.

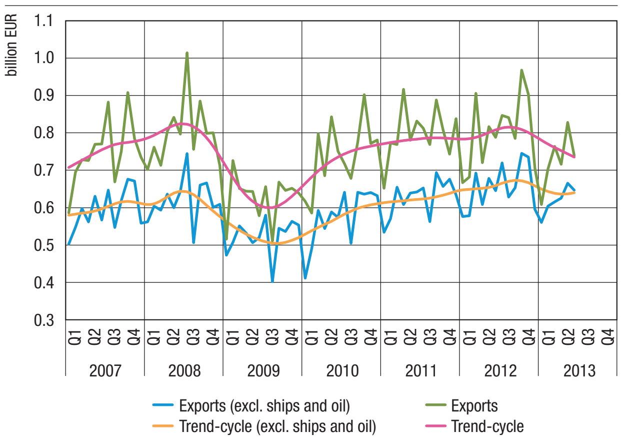
A surplus in the international trade in services was 6.2% larger in the first half of 2013 than in the first half of 2012, mostly owing to the rise in tourism revenues (4.9%). According

Figure 21 Current account balance and its structure



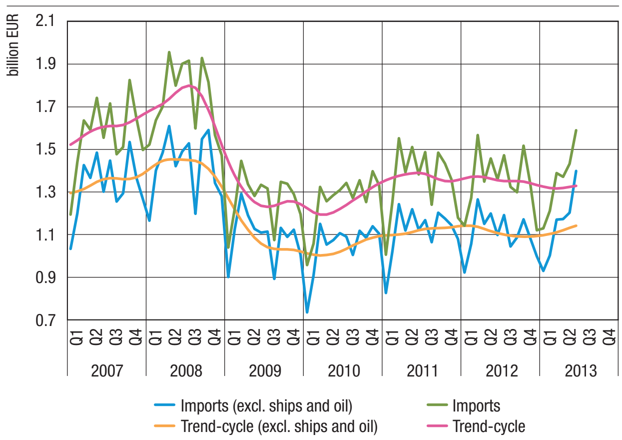
Source: CNB.

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



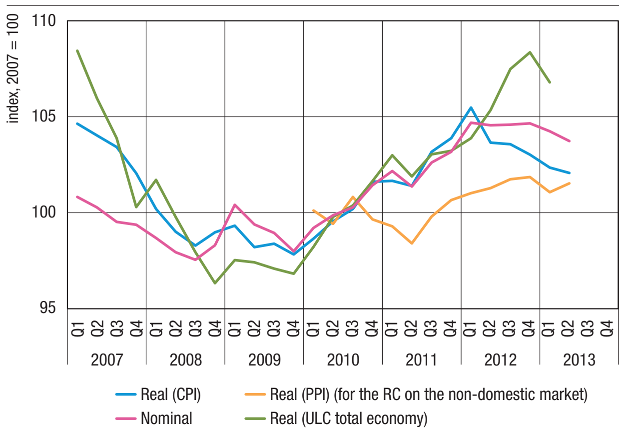
Source: CBS data seasonally adjusted by the CNB.

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



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.
Source: CNB.

to the CBS data, which include commercial accommodation capacities, foreign tourist nights rose by 6.0%, largely thanks to visitors from Great Britain and Poland. A noticeable fall was recorded in the number of nights spent by visitors from crisis-stricken Italy as well as from Russia, Ukraine and Turkey due to the alignment of the visa regime with the EU that came into effect on 1 April 2013. In contrast with tourism, the trade balance in transportation services steadily deteriorated, notably sea cargo transport services.

The steady increase of the positive balance in the current transfers account in the first half of 2013 may be largely attributed to the rise in net income of the private sector arising from worker remittances and other transfers. The current transfers balance of the central government held steady from the first half of 2012 due to the equal rise in revenues and expenditures.

Seasonally adjusted data show that exports of goods were 10.6% lower in the first half of 2013 than in the previous half-year. The unfavourable trend was particularly pronounced in the first quarter but it gradually reversed in the following three months. Exports of ships were very low in the first six months, while exports of oil and refined petroleum products dropped marginally from the second half of 2012. A slump in exports was also observed in a number of other SITC divisions (exports excluding ships and oil dropped by 5.3% from the second half of 2012). Among individual SITC divisions, the sharpest downturn was recorded in exports of agricultural and food products, in particular cereals and cereal preparations, and sugar, sugar products and honey. A decrease was also evident in exports of non-monetary gold (of one third), and metalliferous ores and metal scrap. Exports of some capital goods were also reduced, in particular telecommunication apparatus, a large value of which was exported to the Russian market in mid-2012. Nevertheless, export results improved in some segments; recovery was seen in exports of certain chemical products, iron and steel, while exports of medical and pharmaceutical products and electricity continued to rise.

Imports of goods rose by 1.2% (seasonally adjusted data) from the second half of 2012 to the first half of 2013. Excluding ships, oil and refined petroleum products, imports of which dropped slightly from the preceding six-month period, imports recovered even more, by 5.6%. Still, most of this increase was due to a temporary upsurge in goods imports just before Croatia's accession to the European Union. Changes in trade arrangements, which came into effect in early July and which refer to the trade in solar panels between EU member states and China, prompted a sharp increase in imports of these products in June. Furthermore, the changes in the domestic excise system at the end of the first half of the year encouraged imports of road vehicles, which increased by one half relative to the previous six months. The imports of most of other goods continued to stagnate, while the imports of electricity, natural and manufactured gas experienced a significant drop. A mild recovery was seen in imports of some chemical products and raw materials for industrial production.

The improvement in Croatian export price competitiveness (measured in terms of movements in the real effective exchange rate of the kuna deflated by consumer prices), which had begun in late 2009, came to a stop in mid-2012 when a mild deterioration started. The real effective exchange rate of the kuna deflated by consumer prices appreciated slightly in the first half of 2013 largely due to the rise in domestic administered prices, which do not affect prices of exported goods. This is evident in the real effective exchange rate of the kuna deflated by producer prices (for the RC in the non-domestic market) – it resumed its mild downward trend, which was only briefly interrupted in the previous quarter and which had started in the third quarter of 2011. Data on the real effective kuna exchange rate deflated by unit labour costs in the total economy available from the first quarter of 2013 also suggest a slight deterioration after a noticeable improvement in previous years. Specifically, a growth of domestic unit labour costs stronger than in major foreign trading partners and the nominal effective appreciation resulted in this indicator appreciating relative to the previous quarter.

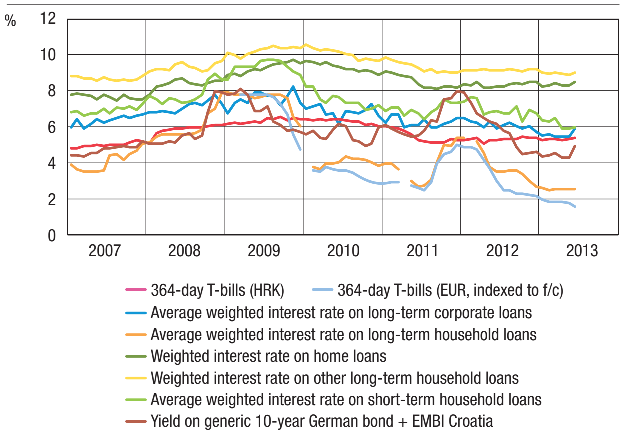
7 Financing conditions and capital flows

Slightly more favourable trends in financing conditions for domestic sectors started in the second half of 2012 and continued into the first six months of 2013, but individual borrowing costs remained relatively high. The easing of tensions about the government debt crisis of eurozone members and abundant liquidity in international financial markets led to an improvement in conditions for government foreign financing in the first half of 2013 as well as for short-term government financing in the domestic market. Domestic costs of corporate financing decreased less, while interest rates on household financing held steady.

The downward trend of the foreign financing costs of the government, estimated in terms of the yield on the German government bond and the EMBI yield spread for Croatia, came to a halt in late 2012. Foreign financing costs were stable through to June 2013, when they started to grow in response to global developments, i.e. the Fed announcement of a possible gradual reduction of incentive measures. Nevertheless, government financing conditions were more favourable than in the same period of 2012, as evident from the required yield of 5.625% on government bonds issued in April 2013 (the required yield on government foreign bonds issued in April 2012 was 6.25%). The fall in the required yield was recorded notwithstanding the downgrading of Croatia's credit rating to below investment grade by two credit rating agencies and the delayed recovery of the Croatian economy. This suggests that the main reason for the decrease in the borrowing price was global effects, i.e. increased risk appetite and abundant liquidity in international financial markets.

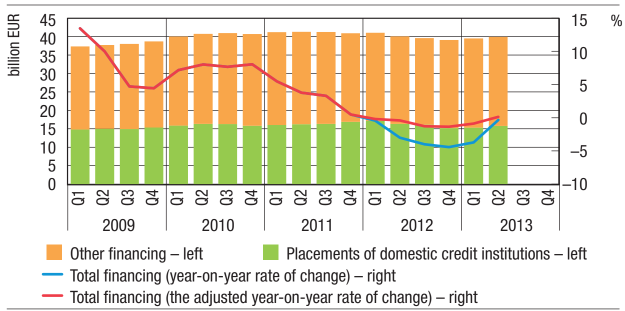
Improved conditions for government external borrowing were also reflected in domestic financing conditions. This was also reinforced by the policy of supporting high liquidity in the

Figure 25 Costs of domestic and foreign financing



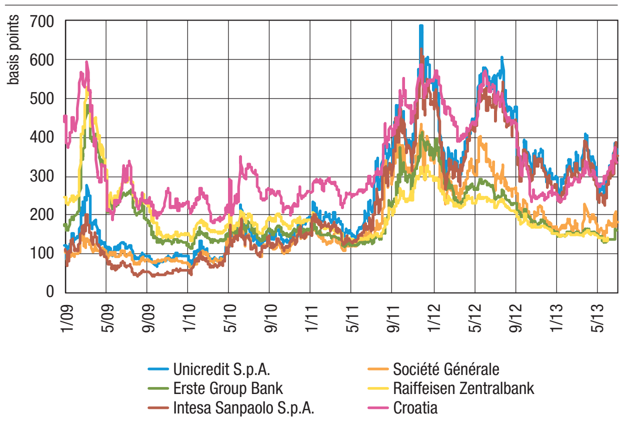
Sources: Bloomberg, MoF and CNB.

Figure 27 Corporate financing by sources



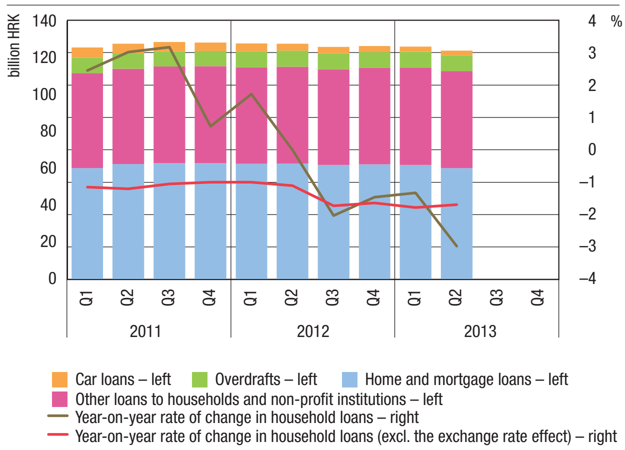
Note: Other financing includes corporate borrowing from domestic leasing companies and direct borrowing from the CBRD, as well as borrowing from foreign banks and affiliated enterprises abroad. The adjusted year-on-year rate of change in total financing is calculated on the basis of data which do not include the effect of the assumption of loans to the shipyards by the Ministry of Finance and the effect of a transaction of one bank which, in an effort to reduce the amount of partly recoverable and fully irrecoverable placements, transferred a total of HRK 5.6bn in its claims to a company indirectly owned by a parent bank (which in turn contributed to the decrease in its debt).
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



Source: CNB.

domestic monetary system, which the CNB has been pursuing for a number of years. Interest rates on one-year T-bills, which steadily decreased in 2012, fell to their lowest level ever in early 2013 and levelled off in the following six months.

CDS spreads on bonds issued by parent banks of the five largest domestic banks edged up in the first quarter of 2013 but by the end of June had dropped to their level of end-2012. The CDS for Italian banks remained higher than those for other banks under review. A marginal decrease in the costs of foreign funding for Croatian banks failed to make a strong impact on the volume of foreign financing of bank subsidiaries in Croatia. More specifically, banks financed the bulk of the increase in domestic placements by reducing their foreign assets and not by foreign borrowing. Furthermore, the external deleveraging trend that characterised the year 2012 was interrupted in the first half of 2013.

Domestic financing conditions for non-financial enterprises improved marginally in 2013, in particular conditions for short-term bank loans. Interest rates on long-term corporate loans also dropped slightly. As interest rates on household loans held steady in the period under review, financing conditions for households remained relatively unfavourable, both for home and other types of loans.

Total corporate financing grew in the first half of 2013, boosted largely by the rise in domestic corporate debt and, to a lesser extent, by the increase in corporate external debt. Corporate debt growth related to both private and state-owned enterprises, though the rise in loans to enterprises in majority government ownership was again slightly stronger. A positive contribution to domestic corporate financing came from the continued granting of loans under the Economic Development Programme intermediated by the CBRD, the implementation of which was secured by the cut in the reserve requirement rate in 2012. Banks placed around HRK 0.6bn worth of loans under the programme in the first six months of 2013, so that the total amount of the funds disbursed reached HRK 1.3bn, which is 37.8% of its potential (HRK 3.4bn).

Observed on an annual basis, total corporate debt held nearly steady from the end of June 2012 to the end of June 2013 (excluding the debt of shipyards assumed as government debt and the transfer of a bank's non-performing placements to a company indirectly owned by the parent bank). This confirms that no significant pick-up in corporate financing has yet begun. More favourable developments can be expected only when the conditions on both credit supply and demand sides change. The aversion of banks to new risks coupled with the high level of total corporate debt and the current stage of the business cycle are the main obstacles to any more vigorous recovery in placements, and are outside the direct influence of the central bank. By pursuing an expansive monetary policy the CNB can secure favourable system liquidity, as it has done ever since the onset of the crisis.

In contrast to the situation with enterprises, loans to the household sector did not grow in 2013. Unchanged financing conditions coupled with the subdued demand due to unfavourable trends in the labour market and uncertainty about future developments continued to stifle bank lending to the household sector, so that the annual decline in total household loans stood at 1.7% at end-May. When loans are broken down by purpose, car loans decreased most, while home loans dipped moderately.

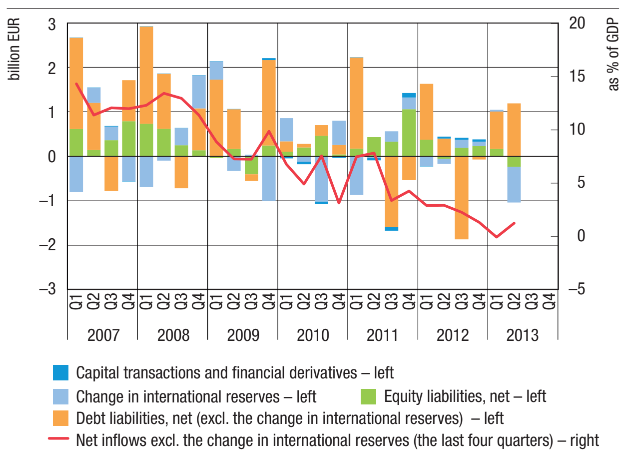
7.1 Capital flows between Croatia and foreign countries

Net foreign capital inflows in the first half of 2013 were approximately equal to those in the same period of 2012. However, their structure changed – inflows of debt capital strengthened and compensated for the fall in equity investment in Croatia. Net capital inflows to the capital and financial account excluding the change in international reserves stood at EUR 2.0bn. International reserves increased in the same period.

Net capital outflow was recorded on the basis of equity investments in the first half of 2013. Along with very modest new equity investments in a small number of activities, the size of direct and portfolio investments was affected adversely by the fact that foreign investors sold their equity holdings in some domestic enterprises to Croatian residents. Net capital outflows would have been even larger if a number of foreign owners had not exchanged their debt claims for holdings in domestic enterprises, particularly in the first two months of 2013. To a small extent, this contributed to the decrease in external debt and the increase in direct equity investment. Furthermore, the negative sign of reinvested earnings, above all in the telecommunication and financial intermediation sectors, was due to smaller profits, which were lower than total dividends paid.

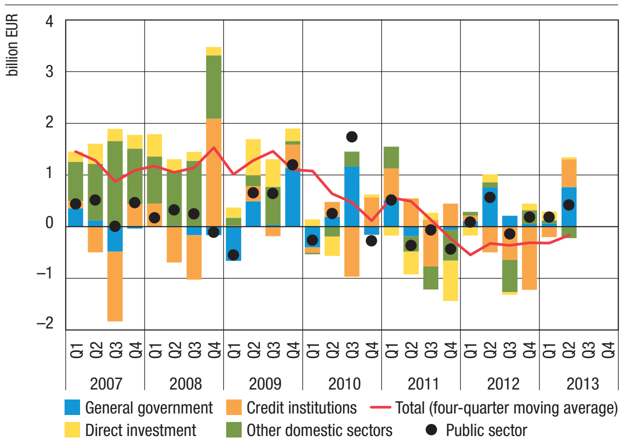
Credit institutions and the government generated the bulk of net inflows of debt capital in the first half of 2013. This deterioration of the foreign position of the government was largely a consequence of the April issue of bonds in the US market worth USD 1.5bn, two-thirds being subscribed by foreign investors. Net debt liabilities of credit institutions also increased. Banks withdrew a substantial amount of their foreign financial assets in the first quarter of 2013 and thus, despite deleveraging, worsened their foreign position. After deleveraging for four consecutive quarters, credit institutions increased their foreign liabilities much more than their foreign financial assets in the second quarter of 2013, which further deteriorated their foreign position. The deterioration of the net foreign position of other sectors in the first half of 2013 reflects mostly the borrowing of a few enterprises from their affiliated enterprises abroad early in the year. The worsening of the net debt position of these domestic sectors was also evident in the total

Figure 29 Capital and financial account flows



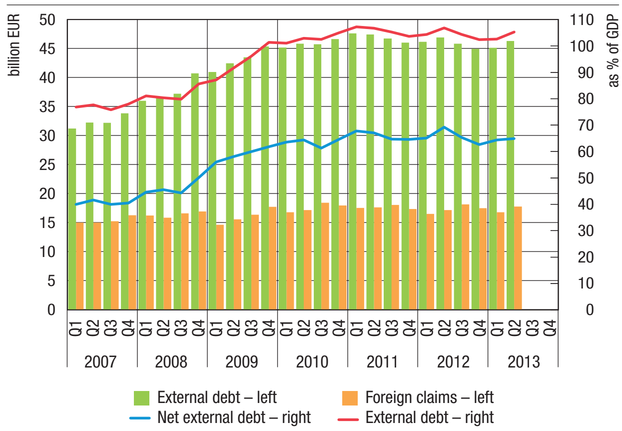
Note: A negative change in international reserves denotes their growth.
Source: CNB.

Figure 30 Gross external debt transactions by sectors



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

Figure 31 Gross and net external debt



Note: Net external debt is calculated as gross external debt stock net of foreign debt claims.
Source: CNB.

net foreign position (international investment position) which, after a deterioration of EUR 0.5bn in the first half of the year, is equivalent to 91.0% of GDP.

The vulnerability of domestic sectors associated with the worsening of their net foreign debt position was mitigated by a sharp increase in international reserves, of EUR 0.8bn in the first six months of 2013. The rise in reserves was largely due to considerable foreign currency inflows from government foreign borrowing. The central bank purchased a portion of these funds, while the government deposited the rest in a foreign currency deposit account with the CNB. By contrast, the April sale of foreign currency to banks led to a decrease in reserves. International reserves stood at EUR 12.0bn at end-June and were sufficient to cover 7.7 months of goods and services imports.

Gross external debt grew by EUR 1.2bn in the first half of 2013, excluding cross-currency changes and other adjustment. This was largely due to central government borrowing and the rise in liabilities of credit institutions. A mild increase in foreign liabilities of other domestic sectors (including those related to direct investment) was primarily associated with private enterprises, while public enterprises and non-banking financial institutions continued to deleverage. Hence, gross external debt ended June at EUR 46.2bn, which is 104.9% of GDP (in the preceding four quarters). Due to a parallel increase in foreign assets of domestic sectors, especially the central bank, net external debt grew slightly less in the first half of 2013 (EUR 1.0bn), standing at EUR 28.6bn at the end of June, or 64.7% of GDP.

8 Monetary policy

In the first half of 2013, the CNB continued the policy of supporting high monetary system liquidity, while maintaining the stable exchange rate of the domestic currency. In its foreign exchange transactions in the first six months of 2013, which were marked by purchases of foreign exchange from the government and sales of foreign currency to banks, the CNB ensured domestic and foreign currency liquidity in the market and stability of the domestic currency. Although developments in monetary and credit aggregates were slightly more favourable than in 2012, there was no significant acceleration of their growth in a setting of delayed economic recovery.

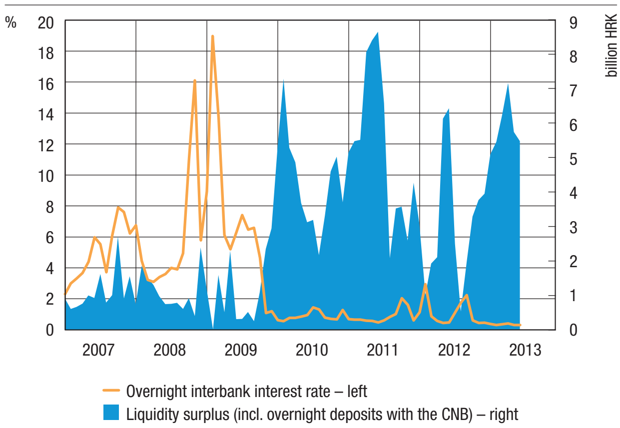
In the first half of 2013, the central bank purchased EUR 208m net by means of foreign exchange transactions, thus creating HRK 1.6bn. The CNB purchased EUR 423m net from the government, creating HRK 3.2bn and sold EUR 215m to banks in the April intervention, withdrawing HRK 1.6bn. The foreign exchange purchased from the government had been borrowed abroad, while the sale of foreign currency to banks was aimed at halting depreciation pressures in the foreign exchange market.

The central bank increased banking system liquidity by reserve money creation, which confirms the expansive orientation of monetary policy. The average surplus of kuna liquidity at the disposal of credit institutions stood at HRK 5.9bn in the first six months of 2013, almost double the average recorded in 2012. As of end-April, i.e. since the enforcement of the decision to cut the rate of remuneration paid on overnight deposits with the CNB from 0.25% to 0%, banks have no longer used overnight deposits and have instead placed total liquidity surpluses in their settlement accounts with the CNB. A high level of liquidity was also reflected in low overnight interest rates in the interbank market and low interest rates on T-bills.

The average exchange rate of the kuna against the euro stood at EUR/HRK 7.57 from January to end-June 2013, or 0.7% over the last year's average. The kuna weakened steadily against the euro from the beginning of the year to mid-April and then became stable. It started to strengthen gradually at the end of June in line with usual seasonal movements. As regards the exchange rate of the kuna against other major global currencies in the first six months of 2013, it strengthened moderately against the Swiss franc and held steady against the US dollar at the levels similar to those in late 2012. Such movements largely reflected the developments in the exchange rates of these currencies against the euro in the global financial market.

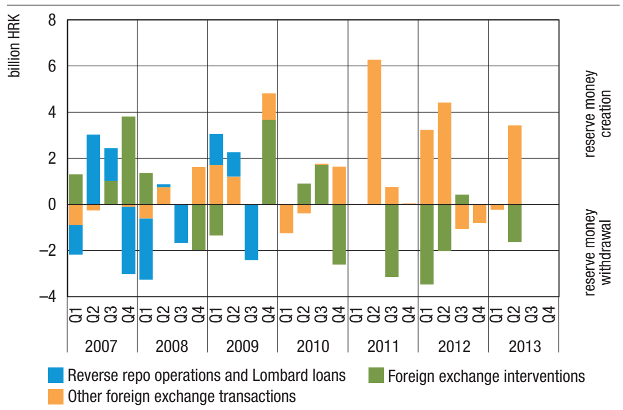
In the first six months of 2013, international reserves of the CNB increased on account of foreign currency inflows from the government's foreign borrowing. A portion of the funds was purchased, while the government deposited the rest in a foreign currency deposit account with the CNB, all of which provided a boost to reserves. The sale of foreign currency to banks had the opposite effect (a decrease in reserves). Gross international reserves stood at EUR 12.0bn at the end of June

Figure 33 Bank liquidity and overnight interbank interest rate



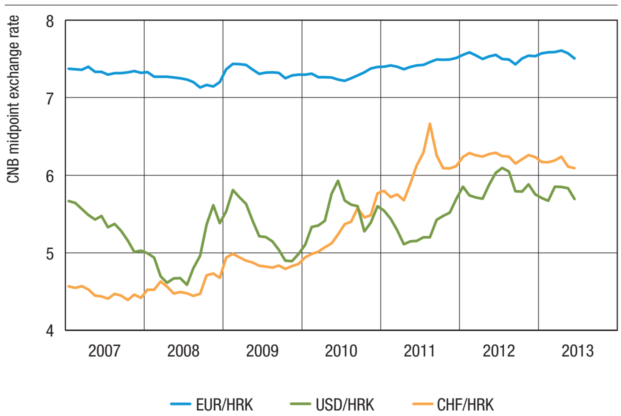
Source: CNB.

Figure 32 Flows of reserve money (M0) creation



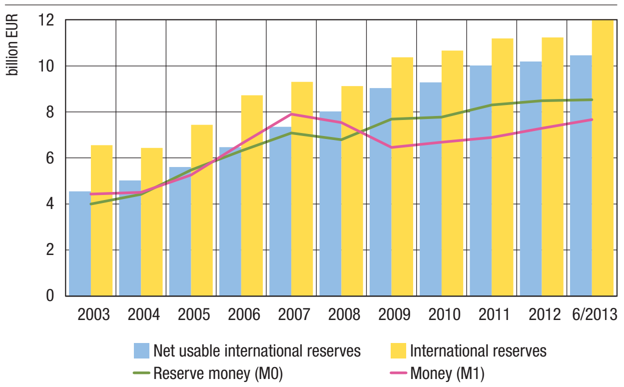
Note: Other foreign exchange transactions include the purchase of foreign exchange from and the sale of foreign exchange to the MoF and foreign currency swaps with banks, where the positive values refer to the purchase of foreign exchange by the CNB.
Source: CNB.

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



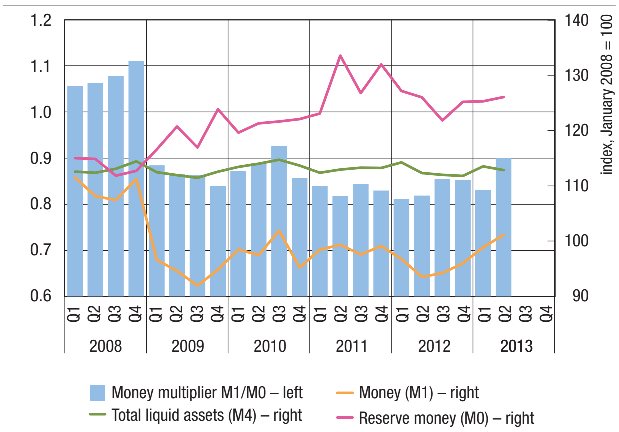
Source: CNB.

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 liabilities (swaps). The most recent data available for M1 refer to the end of August 2013.
Source: CNB.

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



Source: CNB.

2013, an increase of EUR 0.8bn (7.0%) from the end of 2012. Net usable reserves grew by EUR 0.3bn (2.6%) in the same period, to EUR 10.5bn at the end of June. The level of reserves in Croatia thus continued to exceed by a large margin the balance in reserve money (M0) and money (M1).

The broadest monetary aggregate M4 grew by 0.8% in the first half of 2013, excluding the exchange rate effects, which is a slight improvement over the same period of 2012 when it decreased by –0.2%. Within the structure of total liquid assets, money (M1) grew sharply in the current year, largely on account of the rise in corporate demand deposits triggered by the fiscalisation. Savings and time deposits dropped moderately in the same period. Developments in real monetary aggregates in the first half of the year were affected positively by the slowdown in consumer price inflation, so that real seasonally adjusted values of money (M1) and total liquid assets (M4) edged up from the beginning of 2013.

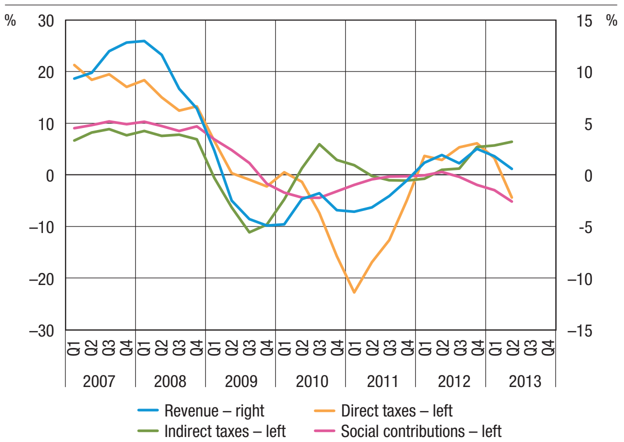
9 Public finance

Consolidated general government revenues decreased by 0.7% from January to June 2013 relative to the same period of the previous year. Profit tax revenues made the largest contribution to the fall in revenues, due to the repeal of the reinvested earnings tax as of January this year and a decline in the profits of economic entities in 2012. A major contribution to the overall fall in revenues also came from revenues from social contributions, largely due to the base effect of the cut in the health insurance contribution rate and a one-off collection of tax debt in May 2012. By contrast, VAT revenues made the largest positive contribution to developments in total revenues. This was mainly the consequence of the tax law amendments, which relate to the increase in the basic VAT rate in March 2012, the replacement of the zero VAT rate for certain products by a 5% rate in January 2013, and the introduction of fiscal cash registers. Furthermore, the rise in VAT revenues was also due to the increase in goods imports in June triggered by the changes in the trade regime following Croatia's accession to the EU.

Consolidated general government expenditures, including the acquisition of non-financial assets, grew by 8.5% in the first six months on an annual level. This was mainly the result of rehabilitation of debt of health institutions and the CIHI, which was evident in an upsurge in expenditures on social benefits. Interest expenses also grew markedly due to public debt growth, while expenditures for subsidies rose sharply as a result of the change in the payment dynamics of support to farmers over the year. Expenses for employees were the only major expenditure category that recorded a noticeable decrease. This was mainly due to the base effect related to the cut in the health insurance contribution rate and a 3% cut in wages to civil servants and government employees in March 2013.

Capital investment of general government related to the

Figure 37 Consolidated general government revenue
year-on-year rate of change of four-quarter moving sums

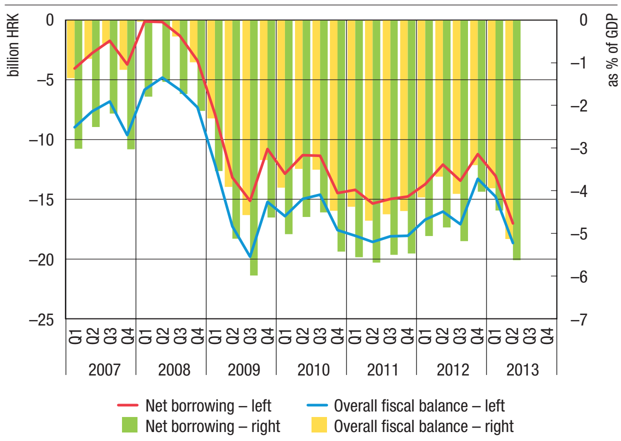


Note: From January 2008 on, CM is excluded from consolidated general government.
Source: MoF (CNB calculations).

Figure 38 Consolidated general government expense
year-on-year rate of change of four-quarter moving sums

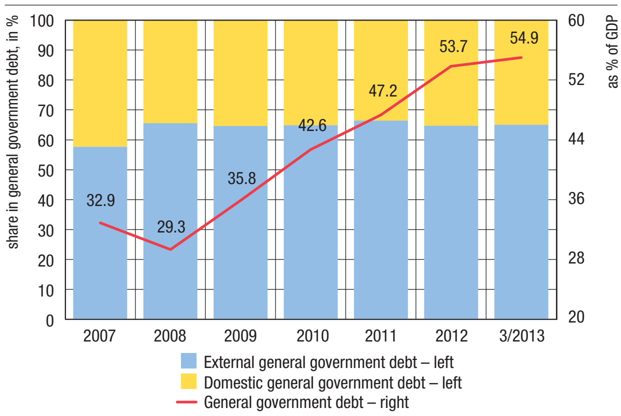
Note: From January 2008 on, CM is excluded from consolidated general government. Expense includes expenditures for the acquisition of non-financial assets.
Source: MoF (CNB calculations).

Figure 39 Consolidated general government balance
four-quarter moving sums



Source: MoF (CNB calculations).

Figure 40 General government debt
end-period stock



Note: From 2008 on, CM is excluded from consolidated general government. The sum of quarterly GDP values in the last four quarters has been used to calculate the ratio of general government debt to GDP at the end of March 2013.
Source: CNB.

acquisition of non-financial assets grew by nearly two-fifths in the observed period, which reflects increased central government investment, while investment activity of local government units was at the same level as in the first six months of the previous year.

The overall fiscal deficit of general government was HRK 12.6bn in the first six months of 2013, an increase of HRK 5.6bn from the same period in 2012. The entire deficit was made at the consolidated central government level, while the local government budget was balanced. As revenue developments were more unfavourable than the Ministry of Finance expected while expenditures on health sector debt were larger than anticipated in the 2013 budget, the deficit has already come close to that projected for the entire year.

Public debt continued to grow strongly as the government met its needs for deficit financing in the first half of the year by new borrowings. The government obtained the bulk of the funds needed in the first quarter by means of T-bill issues and borrowing, while it issued USD 1.5bn worth of foreign bonds early in the second quarter.

10 International 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 balance sheet of the central bank. 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 all banknotes in a convertible foreign currency as well as special drawing rights.

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

10.1.1 Institutional and organisational framework of international reserves management

The Council of the CNB formulates the strategy and policy for international reserves management and sets out the risk management framework. The International Reserves Commission is the body responsible for the development of international reserves investment strategies in accordance with the objectives and criteria set by the Council of the CNB and for the adoption of tactical decisions on international reserves management, while taking into account market conditions.

10.1.2 Principles of and risks in international reserves management

In managing the international reserves of the Republic of Croatia, the central bank is guided by the principles of security and liquidity of investment (Article 19 of the Act on the Croatian National Bank). In this context, it maintains the reserves at a high level of liquidity and appropriate risk exposure and, within the given restrictions, attempts to ensure favourable rates of return on its investments.

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 with financial institutions with the highest credit rating. Interest rate risk, or the risk of a fall in the value of the international reserves portfolio due to unfavourable interest rate changes, can be controlled by means of benchmark portfolios and by investing a part of international reserves in the held-to-maturity portfolio. Currency risk arises from currency fluctuations between the kuna and the euro and the kuna and the US dollar. Liquidity risk is controlled by investing reserves into readily marketable bonds and partly in deposit instruments with short maturities. Operational risk can be controlled by strict separation of functions and responsibilities, precisely defined methodologies and procedures, and regular internal and external audits.

10.1.3 Manner of international reserves management

As provided by 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 the assumed foreign currency liabilities, depending on the way in which international reserves are formed.

The CNB manages international reserves acquired through outright purchases from banks and the MoF, through its membership in the IMF as well as income derived from the investment of international reserves and other CNB assets in line with its own guidelines. The other component of the reserves, formed on the basis of the allocated foreign currency component of reserve requirements, MoF deposits, repo agreements with banks, foreign currency swaps in the domestic market, IMF membership and other assets owned by other legal persons, is managed by the CNB according to the foreign currency liabilities assumed, the aim being to ensure protection against currency and interest rate risks.

The component 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. Held-for-trading portfolios, comprising held-for-trading financial instruments, are important for maintaining the 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. Held-for-trading portfolios are carried at market (fair) value through profit and loss. 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 CNB international reserves includes the terms of gross and net reserves. Gross reserves imply total international reserves. Net reserves imply that component of the reserves managed by the CNB in line with its own guidelines.

10.2 International reserves in the first half of 2013

Total international reserves of the CNB as at 30 June 2013 stood at EUR 12,020.37m, up EUR 784.58m or 7.0% on the balance at the last day of 2012 (EUR 11,235.79m). 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, increased by EUR 264.83m (2.6%) in the first six months of 2013, from EUR 10,197.37m to EUR 10,462.20m. The main drivers of changes in international reserves during the first half of 2013 were foreign currency purchase and sale transactions with the Ministry of Finance and foreign currency sales to banks through interventions.

Table 1 Monthly changes in CNB international reserves
end of period, in million EUR

Month	Total reserves	Net reserves
December 2012	11,235.79	10,197.37
January 2013	11,080.17	10,061.73
February 2013	11,133.44	10,104.32
March 2013	11,276.41	10,246.40
April 2013	12,058.71	10,449.52
May 2013	12,049.23	10,484.37
June 2013	12,020.37	10,462.20
Change		
Jun. 2013 – Dec. 2012	784.58	264.83

Source: CNB.

Table 3 CNB foreign exchange interventions with banks – the first half of 2012 compared to the first half of 2013
in million EUR

	Purchase (1)		Sale (2)		Net (1 – 2)	
	Jan. – Jun. 2012	Jan. – Jun. 2013	Jan. – Jun. 2012	Jan. – Jun. 2013	Jan. – Jun. 2012	Jan. – Jun. 2013
January	0.00	0.00	327.00	0.00	0.00	0.00
February	0.00	0.00	131.00	0.00	0.00	0.00
March	0.00	0.00	0.00	0.00	0.00	0.00
April	0.00	0.00	0.00	214.90	0.00	–214.90
May	0.00	0.00	266.40	0.00	0.00	0.00
June	0.00	0.00	0.00	0.00	0.00	0.00
Total	0.00	0.00	724.40	214.90	0.00	–214.90

Source: CNB.

Table 2 Total CNB turnover in the foreign exchange market, 1 January – 30 June 2013
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	214.90	1,634.91	–214.90	–1,634.91
Ministry of Finance	582.16	4,410.85	159.00	1,207.63	423.16	3,203.22
Total	582.16	4,410.85	373.90	2,842.54	208.26	1,568.31

Source: CNB.

10.2.1 Total CNB turnover in the foreign exchange market in the first half of 2013

In the first half of 2013, the Croatian National Bank intervened in the domestic foreign exchange market through foreign currency purchase and sale transactions with the Ministry of Finance and foreign currency sales to banks in the Republic of Croatia.

The CNB intervened by selling a total of EUR 214.90m in April, with the result that kuna liquidity dropped by HRK 1,634.91m. There were no foreign currency purchases from banks in the first half of 2013.

The CNB purchased EUR 582.16m from the Ministry of Finance, selling to it EUR 159.00m in the first six months of 2013. As a result, a net worth of HRK 3,203.22m was put into circulation.

10.2.2 Structure of international reserves investment

The CNB invests in funds of financial institutions and countries with the highest credit rating. The evaluation of creditworthiness is based on ratings issued by internationally recognised rating agencies (Moody's, Standard & Poor's and FitchRatings) and an internally-developed model for creditworthiness evaluation; there are restrictions on investments in individual financial institutions and countries, which serves to diversify credit risk. The lion's share of CNB foreign currency portfolios is invested in instruments such as government securities of selected countries, instruments issued by international financial institutions, central bank instruments and reverse repo agreements.

The structure of international reserve investments changed from the end of 2012 to the end of the first half of 2013 mainly because the CNB strove to attain higher returns in a setting of low yields, while adhering to the same limits regarding exposure to credit and interest rate risk.

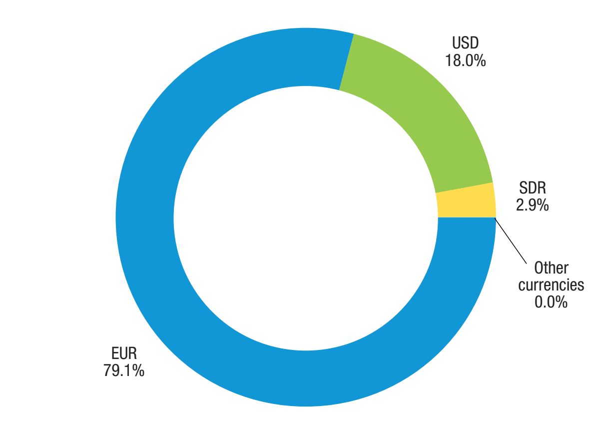
In view of the lingering debt crisis in Europe and uncertainties in financial markets, strict guidelines for investment in some countries and banks remained in effect in the first half of 2013.

Table 4 Structure of international reserves investment as at 30 June 2013
in %

Investment	30 June 2013		31 December 2012	
	Net reserves	Total reserves	Net reserves	Total reserves
1 Countries				
Government bonds	68.99	60.04	65.70	59.63
Reverse repo agreements	2.34	8.21	1.89	2.73
Central banks	11.16	10.17	13.32	15.82
Covered bonds	1.94	1.69	2.45	2.22
2 International financial institutions				
Deposits	0.29	3.19	0.30	3.41
Securities	10.44	9.09	11.11	10.08
Reverse repo agreements	2.33	3.09	1.28	1.16
3 Banks				
Deposits	0.00	1.06	0.01	0.01
Securities[a]	2.51	3.46	3.96	4.94
Total	100.00	100.00	100.00	100.00

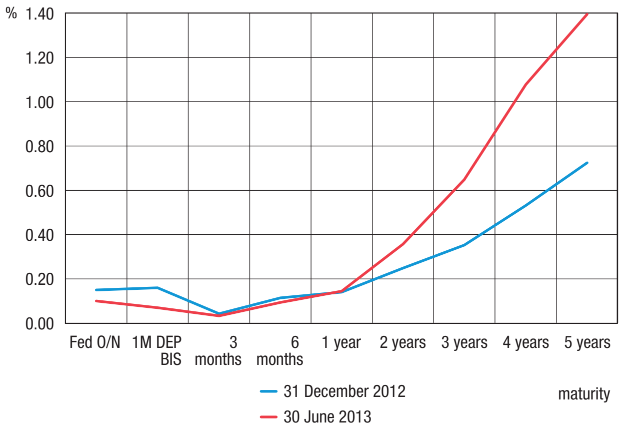
[a] Refers to securities guaranteed by German federal states.
Source: CNB.

Figure 41 Currency structure of total international reserves
as at 30 June 2013



Source: CNB.

Figure 42 Yield curve of American government bonds and other selected instruments



Source: CNB.

Currency structure of international reserves

On 30 June 2013, the share of the euro in the total international reserves was 79.07%, up from 77.81% at the end of 2012 (largely due to the higher euro amount in the account of the Ministry of Finance). The share of the American dollar decreased from 19.05% at the end of 2012 to 18.00% on the last day of June 2013. The share of SDRs also dropped, from 3.14% to 2.93% of the total international reserves, primarily due to an increase in the level of total reserves.

The portion of the reserves arising from allocated foreign currency reserve requirements, MoF foreign exchange funds and repo operations with foreign banks is not exposed to currency risk as it is invested in the same currency in which it was deposited in CNB accounts, i.e. in the currency of the obligation.

Results and analysis of CNB foreign currency portfolio management in the first half of 2013

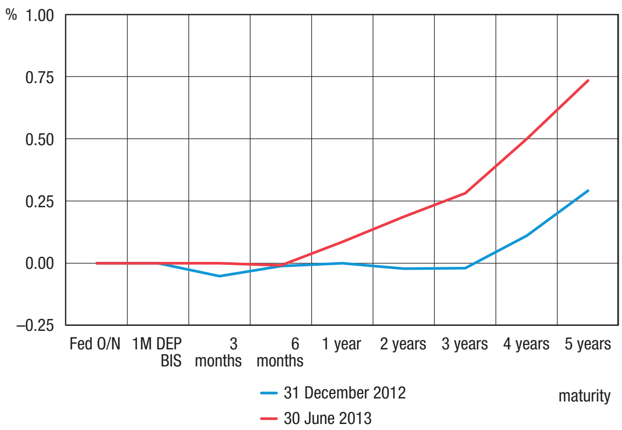
International reserves were invested mostly in American and German government securities as well as securities of other developed countries. In the midst of the ongoing financial crisis, yields on these investments continued to be extremely low.

Yields on instruments maturing in up to a year in which net reserves are invested did not change much in either the European or American market, hovering around zero in the first six months of 2013. By contrast, as the yield curves for US and German bonds maturing in one to five years increased sharply and their slope became much steeper, the effect of bonds of longer maturities was negative.

Net international reserves of the CNB comprise the euro- and dollar-denominated held-for-trading portfolios and the euro-denominated held-to-maturity portfolio. Investments of international reserves are protected against interest rate risk (i.e. the possibility of a significant increase in interest rates) in two ways: by the short duration of the held-for-trading portfolio, which limits potential losses on such portfolios, and by investing a portion of the funds in the held-to-maturity portfolio. In addition to providing security against interest rate risk, such guidelines ensure adequate earning on investment.

The net euro portfolio generated a total income of EUR 42.00m, while the dollar-denominated held-for-trading portfolio generated USD 0.94m in the first half of 2013.

Figure 43 Yield curve of German government bonds and other selected instruments



Source: CNB.

11 Business operations of credit institutions

In the first half of 2013 the weak credit activity and the further materialisation of credit risk reflected the impacts of unfavourable developments in the economic environment on the banking system. The inevitable consequence of the prolonged recession, evident for the fifth consecutive year in the decrease or stagnation in economic activity in the country, was the considerable drop in the profit of banks and the impaired profitability of their business operations.

In the first half of 2013 the banks generated HRK 1.3bn in profit (from continuing operations, before tax), which is 40.8% less profit than in the first half of the previous year. ROAA and ROAE dropped to 0.6% and 3.5% respectively. The decrease in bank profit was primarily the consequence of less interest income from loans, especially from corporate loans, and of the increased provision expenses for credit portfolio losses. The reasons for their growth were the difficulties in the collection of loans, the rise in fully irrecoverable loans, and strong risk aversion, which resulted in a slight growth in loans (2.0% effectively) and in a higher level of less risky but also less lucrative placements. Credit growth was directed primarily to corporates, mostly as loans for working capital and syndicated loans, and to the government units sector. As regards households, the trend of deleveraging continued for the fifth consecutive year, and in the observed period the key impact on the decrease in debt was made by the fall in home loans. The absence of a strong recovery in credit activity and continued unfavourable economic developments led to a further deterioration in loan quality indicators, and at the end of June 2013 the share of B and C risk category loans reached 15.1%. The share of B and C risk category loans in the corporate sector grew considerably, to 26.9%, primarily due to the growth in the mentioned risk category loans in trade and construction activities.

The strong bank deleveraging from the most of the previous year stopped in the first half of 2013, which resulted in a weak growth in assets (1.3% effectively). The increase in sources of financing was primarily based on the growth in deposits of non-residents, but the sources obtained from the majority foreign owners continued to drop. Nevertheless, they still accounted for a significant 16.8% of the total sources of financing. Domestic sources of financing also declined, due to the moderate bank deleveraging in the domestic financial market. As regards the domestic sources of financing, household deposits remained a stable source of bank financing, despite the fact that their growth slowed down considerably, to 1.0% of the effective semi-annual growth. The overall growth in the balance sheet was based on the increase in kuna items, so a moderate currency restructuring of bank balance sheets was noticeable.

The payment of the greater share of profit from the previous year and of the share of profit from previous years was crucially responsible for a slight fall in bank capital. At the same time, the total capital requirements decreased less considerably, so the capital adequacy ratio decreased only slightly, to 20.8%. The high capital adequacy and balance sheet capital-to-liabilities ratios continue to indicate a satisfactory level and quality of bank capital.

11.1 Banks

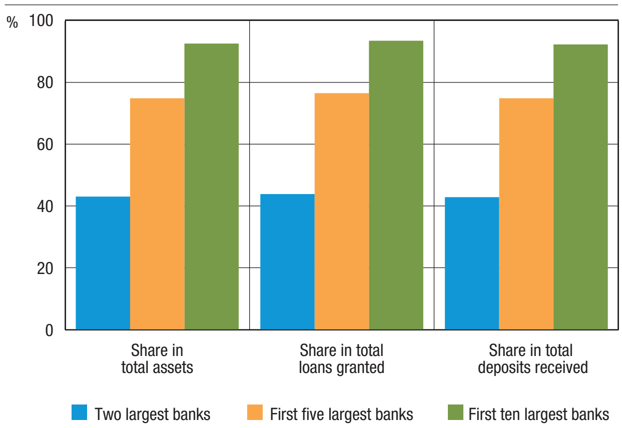
11.1.1 Structural features

At the end of June 2013, there were 36 credit institutions operating in the Republic of Croatia: 30 banks, one savings bank and five housing savings banks. The number of credit institutions remained unchanged from the end of 2012. The banking system assets stayed at the end-2012 level, which is the result of the nominally equal change in bank and housing savings bank assets, though with opposite signs. Therefore a dominant share of bank assets (including one savings bank) of 98.2% at the end of 2013 remained in the structure of the system assets, and the remaining 1.8% referred to the assets of housing savings banks.

System concentration decreased slightly from the end of 2012. The share of the first two largest banks in three key segments (assets, loans and deposits) nevertheless remained relatively high, at around 43.0% (Figure 44). The most noticeable decrease in shares occurred in the first five banks, whose share of assets and deposits in total assets and deposits of all banks decreased by 0.7 percentage points, and the share of loans by 0.6 percentage points. By contrast, the next five banks recorded a growth in assets, mostly from a rise in deposits, as well as from an increase in credit activity, due to which the concentration indicators of ten largest banks eventually remained unchanged. Thus the share of assets of the first ten banks at the end of June 2013 was 92.6%, just like at the end of 2012, while the shares of loans and deposits changed only slightly and reached 93.5% and 92.3% respectively.

The ownership structure of banks remained unchanged in the first six months of 2013. A total of 16 banks were in the majority ownership of foreign shareholders and 15 banks were in the majority ownership of domestic shareholders (Table 5). Due to the noticeable growth rates of several banks the share of banks in domestic ownership increased to 10.3% of

Figure 44 Shares of assets, loans and deposits of the largest banks in total assets, loans and deposits
as at 30 June 2013



Source: CNB.

Table 5 Ownership structure of banks and their share in total bank assets

end of period

	Dec. 2011		Dec. 2012		Jun. 2013	
	Number of banks	Share	Number of banks	Share	Number of banks	Share
Domestic ownership	15	9.4	15	9.9	15	10.3
Domestic private ownership	13	4.9	13	5.2	13	5.3
Domestic state ownership	2	4.5	2	4.8	2	5.0
Foreign ownership	17	90.6	16	90.1	16	89.7
Total	32	100.0	31	100.0	31	100.0

Source: CNB.

the total assets of all banks. The largest number of banks (six) was in the ownership of Austrian shareholders, and the assets of those banks accounted for a high 60.6% of the total assets of all banks. Four banks were in the ownership of Italian shareholders and their total market share stood at 18.5%. Shareholders from France and Hungary accounted for slightly more than 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.

11.1.2 Bank balance sheet and off-balance sheet items

Assets

At the end of the first half of 2013 bank assets stagnated at the end-2012 level (Table 6). The trend of decline in total bank assets present for most of the previous year continued in the first quarter of 2013, and it was interrupted in the second quarter by the rise in deposits of non-residents and domestic corporates. In the first six months of this year the developments in assets were significantly influenced by the appreciation of the kuna against the three most widely represented foreign currencies, and without that influence the achieved increase in assets would be considerably higher and would amount to HRK 5.4bn or 1.3%. The overall growth in assets was based on the increase in kuna items (by HRK 6.6bn or 4.6%), while the foreign currency assets effectively decreased, which is indicative of a slight balance sheet currency restructuring.

Bank loans granted (net) rose in the first half of 2013 by HRK 289.3m or only 0.1%. The strengthening of the kuna significantly affected the stagnation in loans in the observed period, and without that impact the increase in net loans would reach HRK 4.3bn or 1.6%. The considerable difference between the nominal and the effective growth is the consequence of a high share of loans subject to the impact of the movement of the kuna exchange rate against foreign currencies, which is around three quarters of all net loans. The bulk of the growth in loans in the first half of 2013 focused on corporates and government units, and households continued to deleverage. Reflecting the prolonged recession and unfavourable developments in the economy, there was no fall in the intensity of credit risk materialisation, as evidenced by difficulty in

Table 6 Structure of bank assets

end of period, in million HRK and %

	Dec. 2011		Dec. 2012			Jun. 2013		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
Money assets and deposits with the CNB	53,054.6	13.0	51,169.4	12.8	–3.6	51,885.5	13.0	1.4
Money assets	6,194.1	1.5	6,438.9	1.6	4.0	6,817.8	1.7	5.9
Deposits with the CNB	46,860.5	11.5	44,730.5	11.2	–4.5	45,067.8	11.3	0.8
Deposits with banking institutions	26,957.1	6.6	23,847.3	6.0	–11.5	21,906.4	5.5	–8.1
MoF treasury bills and CNB bills	11,580.0	2.8	10,701.6	2.7	–7.6	12,629.5	3.2	18.0
Securities	24,869.6	6.1	32,095.1	8.0	29.1	30,231.2	7.6	–5.8
Derivative financial assets	673.9	0.2	910.6	0.2	35.1	1,540.0	0.4	69.1
Loans	276,727.5	68.0	267,965.1	67.0	–3.2	268,254.5	67.0	0.1
Loans to financial institutions	7,140.1	1.8	10,130.1	2.5	41.9	9,882.8	2.5	–2.4
Loans to other clients	269,587.4	66.2	257,835.1	64.5	–4.4	258,371.7	64.6	0.2
Investments in subsidiaries, associates and joint ventures	3,288.7	0.8	3,120.0	0.8	–5.1	3,360.7	0.8	7.7
Foreclosed and repossessed assets	868.4	0.2	1,296.8	0.3	49.3	1,370.6	0.3	5.7
Tangible assets (net of depreciation)	4,365.1	1.1	4,284.0	1.1	–1.9	4,190.0	1.0	–2.2
Interest, fees and other assets	7,650.6	1.9	7,414.7	1.9	–3.1	7,640.3	1.9	3.0
Net of: Collectively assessed impairment provisions	3,070.6	0.8	2,888.9	0.7	–5.9	2,869.6	0.7	–0.7
Total assets	406,965.0	100.0	399,915.7	100.0	–1.7	400,139.1	100.0	0.1

Source: CNB.

collection and the growth in loan losses. The increase in the loan value adjustments by almost 8.0% continued to decelerate the growth in bank assets.

In the first half of the year more pronounced changes were visible in items indicating deposits with the CNB. Due to the reduction in the remuneration rate on overnight deposits[3] the banks no longer use the overnight deposit facility with the CNB for their surplus liquidity, and so the total amount of those deposits was transferred from the account of the deposited amount with the CNB to the banks' giro accounts (settlement accounts). The reduction in deposits with financial institutions by 8.1% was probably the consequence of the decrease in foreign currency liabilities; in accordance with the applicable regulations, foreign currency liabilities need to be covered by liquid foreign currency claims in the amount of 17%. The channelling of funds from deposit accounts with other foreign financial institutions to accounts held with parent banks was noticeable, particularly influenced by one bank and the parent bank's bond repayment upon maturity. The average monthly coverage of foreign currency liabilities by foreign currency claims decreased slightly from end-2012, but it was still larger than prescribed, by two percentage points on average.

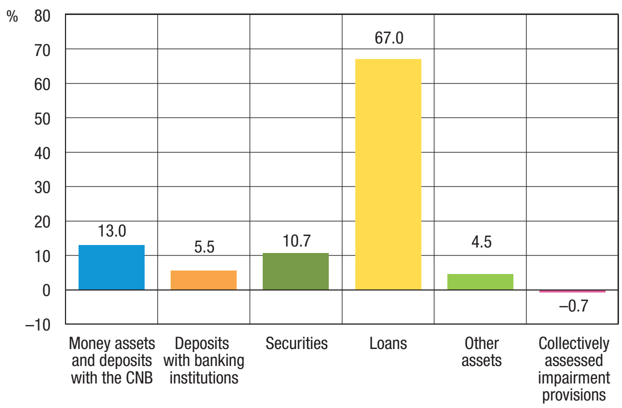
Total bank investments in securities remained stable at the level from the end of the previous year and at the end of June reached HRK 42.9bn, which accounted for 10.7% of the total assets of all banks (Figure 45). Almost all investments referred to debt securities, and the significance of equity securities, despite the rise in investments in foreign companies, remained negligible (less than 1%). The bulk of the total investments of banks in debt securities (62.4%) related to the securities of the Republic of Croatia, most notably bonds and T-bills. In the first half of 2013 their significance additionally increased, due to the growth in those investments by an additional HRK 2.5bn or 10.6%, the major part of which related to T-bills of the Ministry of Finance.

Also noteworthy for their share in the structure of debt securities are investments in securities of foreign governments (14.8%), foreign financial institutions (7.9%) and domestic corporates (10.6%). Of those items only investments in the securities of corporates increased at the end of June, due to an increased purchase of bills of exchange. The observed reduction in investments in securities of foreign financial institutions (by HRK 2.0bn or 37.5%) was only temporary and it was influenced by one bank. The fall in debt securities of foreign governments by 9.5% almost completely referred to one bank and the reduction in investments in T-bills of a foreign central bank.

Derivative financial assets were prominent among other items of assets with high growth rates, with a 69.1% increase in the first half of the year, particularly on the basis of contracts entered into with foreign banks, predominantly with the majority foreign owners. At the same time claims on the basis of swaps and forwards with the exchange rate as the underlying variable increased the most. Investments in branches, associates and joint ventures rose by 7.7% due to their growth in two banks. A greater part of that growth was achieved through increased investments in the capital of non-financial institutions. At the system level, those investments continue to

3 In line with the Decision on the interest rates and remunerations of the Croatian National Bank (OG 45/2013) the remuneration rate on overnight deposits with the central bank was reduced from 0.25% to 0%.

Figure 45 Structure of bank assets
as at 30 June 2013



Source: CNB.

be considerably lower than the prescribed limit (30% of own funds at most) and amount to 1.8%.

The deterioration in the loan portfolio quality and the difficulty in collecting claims continue to result in the growth in assets acquired in exchange for claims, but that growth of 5.7% was much lower than in the previous four years. Acquired assets still account for a very low share in the total assets of banks (0.3%), although the noticeable fall in the part of those assets intended for sale within one year (17.1%) suggests that the banks expect certain difficulties in selling them. Investments in assets acquired during a period of longer than two years, the level of which is limited in relation to own funds, comprised almost half of the total amount of the acquired assets. The average ratio of those investments to own funds of all banks stagnated at a relatively low 9.3%, but only in certain banks was this ratio high.

Liabilities and capital

A slight increase in bank liabilities in the first half of 2013, by HRK 1.1bn or 0.3% was based on the increase in non-resident sources (2.1%), that is, foreign financial institutions, and total domestic sources decreased (0.4%). Compared to end-2012, only deposits rose (1.3%) and all other types of sources decreased, especially loans received (6.6%). Excluding the exchange rate effects, the growth in liabilities was much higher and stood at HRK 4.3bn or 1.3%. In the first half of the year the bank liabilities saw a significant currency restructuring, which resulted in the rise in kuna liabilities by HRK 9.1bn or 8.5% and in the decrease in foreign currency liabilities by HRK 8.0bn or 3.4% (HRK 4.8bn or 2.0% effectively).

The growing importance of non-residents in sources of bank financing was due to the increase in deposits of other foreign financial institutions (other than majority foreign owners). One bank stood out for the amount of the change, where this growth was only temporary. Sources received from majority foreign owners continued to go down (0.8%), but this trend was much slower than in the previous year, due to the effects of increased usage of those sources during the second quarter in some banks. At the quarterly level, this ended the strong deleveraging of banks against their parent banks. The funds of majority foreign owners continued to be a significant source

Table 7 Structure of bank liabilities and capital

end of period, in million HRK and %

	Dec. 2011		Dec. 2012			Jun. 2013		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
Loans from financial institutions	17,320.7	4.3	16,802.9	4.2	–3.0	15,818.0	4.0	–5.9
Short-term loans	5,383.5	1.3	3,273.9	0.8	–39.2	2,014.5	0.5	–38.5
Long-term loans	11,937.2	2.9	13,529.0	3.4	13.3	13,803.5	3.4	2.0
Deposits	281,286.7	69.1	275,844.0	69.0	–1.9	279,470.4	69.8	1.3
Transaction account deposits	44,901.6	11.0	47,466.3	11.9	5.7	52,846.6	13.2	11.3
Savings deposits	21,074.5	5.2	21,229.8	5.3	0.7	20,845.4	5.2	–1.8
Time deposits	215,310.6	52.9	207,147.9	51.8	–3.8	205,778.3	51.4	–0.7
Other loans	31,852.3	7.8	30,599.2	7.7	–3.9	28,477.4	7.1	–6.9
Short-term loans	3,938.4	1.0	4,669.1	1.2	18.6	5,004.0	1.3	7.2
Long-term loans	27,914.0	6.9	25,930.1	6.5	–7.1	23,473.5	5.9	–9.5
Derivative financial liabilities and other financial liabilities held for trading	1,383.7	0.3	1,752.3	0.4	26.6	1,418.7	0.4	–19.0
Debt securities issued	0.0	0.0	300.0	0.1	0.0	300.0	0.1	0.0
Short-term debt securities issued	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	300.0	0.1	0.0	300.0	0.1	0.0
Subordinated instruments issued	1,366.2	0.3	1,391.0	0.3	1.8	1,365.5	0.3	–1.8
Hybrid instruments issued	3,601.1	0.9	3,243.0	0.8	–9.9	3,205.7	0.8	–1.1
Interest, fees and other liabilities	14,387.4	3.5	12,611.7	3.2	–12.3	13,557.6	3.4	7.5
TOTAL LIABILITIES	351,198.2	86.3	342,544.1	85.7	–2.5	343,613.4	85.9	0.3
Share capital	33,805.6	8.3	34,231.0	8.6	1.3	34,146.2	8.5	–0.2
Current year profit/loss	3,804.4	0.9	2,723.9	0.7	–28.4	986.3	0.2	–63.8
Retained earnings/loss	13,705.2	3.4	15,666.4	3.9	14.3	16,820.4	4.2	7.4
Legal reserves	1,058.6	0.3	1,081.1	0.3	2.1	1,112.1	0.3	2.9
Reserves provided for by the articles of association and other capital reserves	3,643.6	0.9	3,292.4	0.8	–9.6	3,222.1	0.8	–2.1
Revaluation reserves	–188.0	0.0	427.0	0.1	–327.1	337.7	0.1	–20.9
Previous year profit/loss	–62.6	0.0	–50.1	0.0	–19.8	–99.2	0.0	97.8
TOTAL CAPITAL	55,766.8	13.7	57,371.6	14.3	2.9	56,525.7	14.1	–1.5
TOTAL LIABILITIES AND CAPITAL	406,965.0	100.0	399,915.7	100.0	–1.7	400,139.1	100.0	0.1

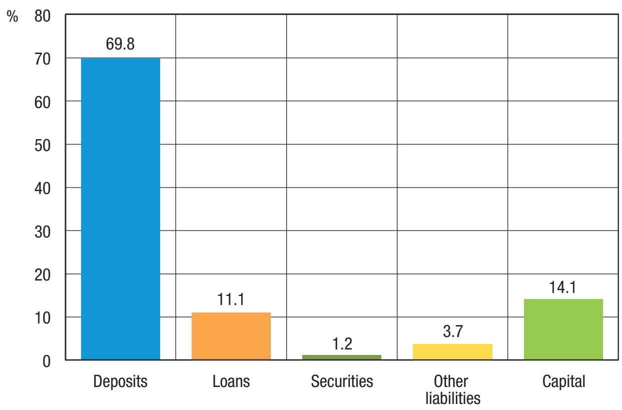
Source: CNB.

of bank financing, with a share of 16.8% in the total sources of financing at the end of June 2013. Almost all banks in foreign ownership used sources from majority foreign owners, but the range of usage varied greatly among the different institutions, and only a few banks reported a high level of dependence on those sources. The kuna component continued to account for a little over one fourth of sources from majority foreign owners. In the first half of 2013 it grew by 12.5%, but the drop in the foreign currency component resulted in a very slight reduction of total sources from majority foreign owners.

The most significant influence on reduction of domestic sources came from the moderate deleveraging of banks in the domestic financial market on the basis of loans received from financial institutions (8.7%). At the same time domestic deposits only slightly rose (0.2%), due to opposite trends in the deposits of certain institutional sectors. The fall in deposits of government units (5.2%) was thus compensated by the growth in deposits of corporates (1.4%). The last reported increase in deposits of corporates in the first half of the year was achieved in 2007. The increase reflected changes from the second quarter and mostly related to deposits in transaction accounts. A great share of their increase was the consequence of the rise in the balance in transaction accounts of pharmaceutical wholesalers, owing to the decrease in the health sector debt to that activity. The remaining, smaller part of the increase was mostly concentrated in trade and may be attributed to the loans received from banks, as well as to the tightened fiscal policy measures. Household savings stagnated, despite the noticeable growth in deposits of that sector in some banks.

The stagnation in household deposits in the first half of the year was partially determined by the exchange rate effects, and those effects excluded, a slight effective growth of 1.0% was achieved. The increase in kuna savings and some savings in the American dollar contributed to that growth the most, while savings in the euro and Swiss franc was effectively reduced. Household deposits continued to be the most significant source of financing, with a share of 50.7% in sources and almost 60.0% in total deposits. The double-digit annual growth rates of household deposits which were present in the pre-crisis period had decreased at the beginning of the crisis, but only in 2011 were they seriously disturbed. Similar developments continued in the previous year, and in the first six months of this year the rise in those deposits additionally slowed down, which may be attributed to the compounding of the principal.

Figure 46 Structure of bank liabilities and capital
as at 30 June 2013



Source: CNB.

The deposits in foreign currency continue to have a dominant share of 77.6% in the structure of household savings, and their amount decreased in the first half of 2013 by 1.4%. At the same time the kuna deposits went up by a considerable HRK 1.7bn or 4.9% which was equally attributed to the growth in kuna deposits in transaction accounts and in kuna time deposits. This led to a slight rise in the share of kuna deposits in household time deposits, but it is still relatively low, less than 15.0%. Although as mentioned there was an increase in deposits in the American dollar, household deposits in all other foreign currencies declined.

In the first half of 2013, instruments with the characteristics of capital, subordinated and hybrid instruments, continued to moderately decline (1.8% and 1.1% respectively), but their share in total liabilities and capital stagnated at the level of the end of the previous year. Only one bank continued to use financing by issued debt securities, in an unaltered amount and with very low impact on bank liabilities and capital.

The decline in bank capital by 1.5% contributed to the stagnation in total liabilities and capital. However, at the end of the first half of 2013, capital continued to account for a high share in total liabilities and capital (Figure 46). Payments from profit had a key impact on the reduction in capital. The banks allocated a smaller part of the profit achieved in 2012 (HRK 2.7bn) to reserves and retained earnings (HRK 1.1bn), and a greater part is foreseen for payment. By the end of June 2013 dividends in the total amount of HRK 1.2bn were paid, with an additional HRK 0.4bn to be paid in the future. Measured as the share in profits achieved in 2012, dividends accounted for 60.9%. From 2005 onwards, a higher percentage of dividend payment was recorded only in 2010 (75.9%), based on the results achieved in 2009.

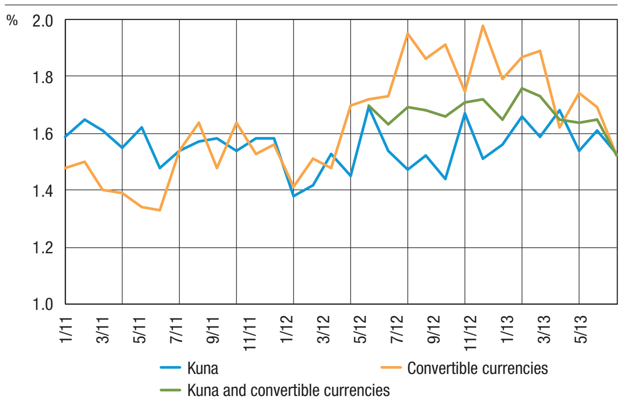
Despite the payment of a larger share of the profit, the total amount of retained earnings at the level of all banks was still significant and amounted to HRK16.8bn, and with all capital reserves it reached HRK 21.5bn, which accounted for around 40% of total bank capital at the end of the first half of 2013. The distribution of those capital buffers within the system is rather uneven, thus the total retained losses of banks amounted to as much as HRK 916.1m. In order to cover previous years' losses, two banks by the end of June conducted a simplified reduction of the initial capital and a recapitalisation and they created capital reserves, which had a positive impact on their capital. Only one bank increased its share capital, for the sake of support to its perceptible growth.

Liquidity indicators

Bank balance sheets still indicate a strong cumulative maturity mismatch of short-term assets and liabilities[4], which increased again after a considerable reduction in the previous year and at the end of June stood at HRK 66.2bn. The rise in the negative cumulative gap since the end of 2012, by HRK 11.8bn or 21.7% is at the same time under the influence of both the reduction in short-term assets (particularly loans and deposits granted) and the increase in short-term liabilities (in transaction accounts). This reduced the short-term assets to short-term liabilities ratio by 3.9 percentage points, and it fell to 75.3%. The majority of changes in short-term assets arose from the extension of loan and liabilities maturities, while the growth in liabilities in transaction accounts increased the need for funds with the shortest maturity (up to 15 days). The banks tried to cover those needs with the rise in those asset items which mature within 15 days, especially in debt securities. Eventually the banks achieved a positive gap on that maturity bracket and on the 15-day to 1-month maturity bracket, so the assets which matured within one month were sufficient to cover all liabilities with that maturity bracket.

The banks generally still have significant surplus liquidity, although the amount of that surplus decreased slightly from end-year. Readily marketable assets (RMA)[5] went down by 1.7% and amounted to HRK 58.8bn. With respect to the stagnation in bank assets on a semi-annual level, the RMA share in total bank assets decreased moderately to 14.7%. The most significant of the changes in readily marketable assets were the changes in their currency structure, which indicate a stronger

Figure 47 Minimum liquidity coefficient for the period of up to 1 month



Note: From 1 May 2012 until 30 June 2013, by way of exception, the credit institutions meet the minimum liquidity coefficient requirement on a collective basis, i.e. for kuna and all convertible currencies combined.
Source: CNB.

4 Short-term cumulative maturity mismatch of assets and liabilities (cumulative gap) is calculated as the difference between assets (net) and liabilities with the same remaining maturity bracket and includes all categories of the remaining maturity bracket up to one year. A positive gap means that the amount of assets is greater than the amount of liabilities, while the opposite situation is termed a negative gap.

5 Readily marketable assets mean assets which may be quickly (within four working days) and easily (without substantial losses) turned into cash.

share of kuna items in relation to the end of 2012. This is a consequence of a reduction in items in convertible currencies by 15.6% and at the same time of the increase of kuna items by almost 10.0%. The fall in the readily marketable assets in convertible currencies was attributable to a 32.0% lower amount of deposits/loans with credit institutions, and one bank significantly contributed to that decrease by reducing a part of the assets which may be turned into cash within four working days. This growth in readily marketable assets in kuna in relation to the end-year balance is the result of major investments in T-bills of the Ministry of Finance and of the increased surplus liquidity on the account with the CNB. Due to those changes in the structure of readily marketable assets, the share of deposits/loans with credit institutions decreased by 7.4 percentage points, to 18.7%. At the same time shares of all other items went up, and the greatest increase was seen in deposits with the CNB (to 30.1%) and in T-bills of the Ministry of Finance (to 21.9%).

The estimated money inflows continue to more than sufficiently cover the estimated outflows under stressed conditions, so the minimum liquidity coefficients (MLC)[6] remained significantly above the proscribed minimum (Figure 47). However, the first half of this year suggested there was a slight tendency for them to decrease from end-2012. At the end of June 2013 the total liquidity coefficient calculated for kuna and convertible currencies together for the period of up to one week was 2.1, and for the period of up to one month 1.5.

Currency adjustment of bank assets and liabilities

Foreign currency items as well as kuna items indexed to a foreign currency normally account for two thirds of the bank total assets and liabilities. The share of foreign currency items in assets is somewhat higher than in total liabilities and capital. The banks hedge this surplus of foreign currency assets i.e. the long spot foreign exchange position by means of forwards in almost equal amounts thus bringing their direct exposure to currency risk to a low level. The total open net foreign currency position of banks at the end of June 2013 was HRK 975.0m or 1.8% of own funds, which is significantly less than the legally prescribed maximum of 30%. Exposure to currency risk in several banks is close to the ceiling, and at the end of June as much as eleven banks were not required to allocate capital to cover currency risk because their total open foreign currency position increased by the net position in gold was less than 2% of own funds at the end of June.

Three currencies accounted for more than 98% of the total foreign currency sub-balance sheet (euro, Swiss franc and American dollar), and the euro balance sheet items were dominant with the share of around 84.5% in foreign currency assets and foreign currency liabilities. In the first six months of 2013 the kuna exchange rate strengthened against all three mentioned currencies (by 1.3%, 3.4% and 0.4% respectively), and this had a considerable impact on effective changes in almost all balance sheet items. The increase in assets was achieved due to the growth in kuna items, and kuna liabilities rose even stronger, so the first half of 2013 was characterised also by a slight currency restructuring of the bank balance sheet. The share of kuna items in the bank balance sheet rose to its highest level in the past four years.

The foreign currency assets of banks stood at HRK 252.0bn, accounting for 63.0% of total bank assets. Since end-2012 the foreign currency assets had decreased by HRK 6.3bn or 2.5% (0.5% if exchange rate effects are excluded). At the same time the kuna share of assets rose by HRK 6.7bn or 4.6%, leading to a growth in the kuna share in total assets to 37.0% (by 1.6 percentage points). Total foreign currency assets mostly decreased due to the reduction in kuna assets indexed to a foreign currency by HRK 5.6bn (3.5%), while the assets in foreign currencies decreased by only 0.8%. Securities and loans had the key impact on that fall. Debt securities of foreign issuers decreased in favour of domestic, primarily T-bills of the Ministry of Finance issued in kuna. Kuna loans indexed to a foreign currency decreased, mostly due to household deleveraging, and foreign currency loans rose, especially loans to central government and loans to public enterprises.

Total foreign currency liabilities stood at HRK 227.0bn, which accounted for 66.0% of total liabilities and 56.7% of total liabilities and capital. Compared with the end-2012 those liabilities fell by HRK 8.0bn or 3.4% (2.1% if exchange rate effects are excluded), due to the equal reduction in loans and in deposits received. As was the case with foreign currency assets, the increase in kuna liabilities was stronger than the reduction in foreign currency items, by HRK 9.1bn or 8.5%. This was almost exclusively due to the growth in kuna deposits of all sectors, primarily non-residents, domestic corporates and households. Kuna items reached 34.0% in liabilities and 43.3% in liabilities and capital.

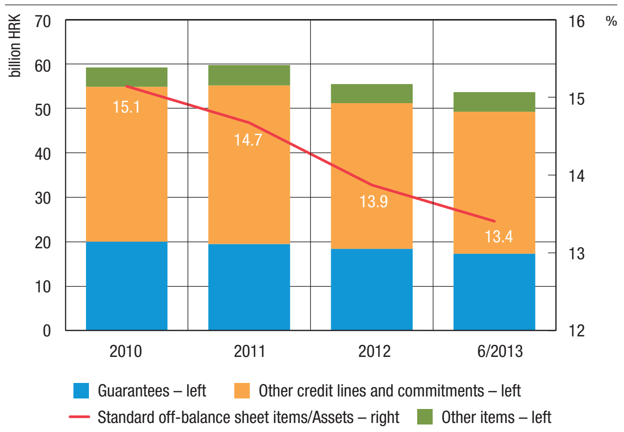
Broken down by currencies, in the first half of 2013 assets in Swiss francs decreased the most, by 13.7% (10.5% effectively), due to the reduction in household loans and deposits with foreign financial institutions. The fall in euro assets by 0.6% is attributable to the change in the kuna exchange rate, and without that influence those assets would have gone up by 1.2% on the basis of the growth in loans to corporates and the government. On the liabilities side, items in almost all currencies decreased nominally and effectively, and the greatest decrease was recorded in items in the Swiss franc (14.4%, effectively 11.0%) and the euro (2.1%, effectively 0.9%).

Standard off-balance sheet items

At the end of the first half of 2013, standard off-balance sheet items stood at HRK 53.7bn, which is a decline of a further HRK 1.8bn or 3.3% from the end of the previous year (Figure 48). Somewhat more than two thirds of these items are denominated in kuna, and almost the entire remainder in euro, so the effects of the change in the kuna exchange rate were considerably lower than in the balance sheet, thus the effective decrease from end-2012 was 1.7%. With the exception of 2011 which was marked by a very moderate growth, since the beginning of the crisis the banks have experienced a decreasing trend in the amounts of standard off-balance sheet items. Due to the stagnation in assets the ratio between these items and

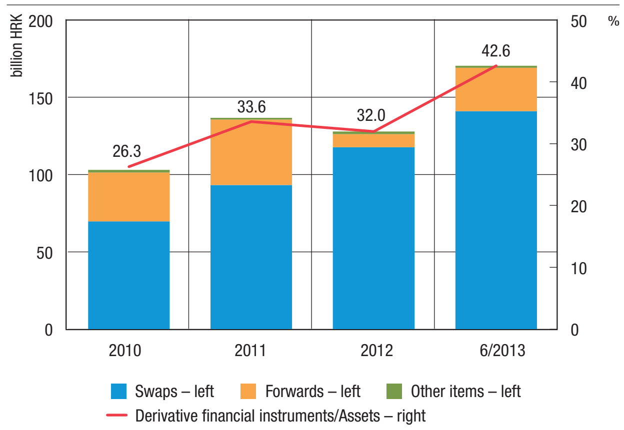
6 The minimum liquidity coefficient (MLC) is calculated as a ratio between expected inflows (including readily marketable assets) and the expected outflows in stressed conditions in two given periods (up to one week and up to one month), and it needs to be equal to or greater than one. MLC is calculated for kuna, all convertible currencies combined and for each non-convertible currency individually (if significant). By way of exception, from 1 May to 31 June 2013, 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 48 Bank standard off-balance sheet items



Source: CNB.

Figure 49 Bank derivative financial instruments (notional amount)



Source: CNB.

assets also continued to decline, to 13.4% at the end of June 2013. At the end of 2008, this ratio stood at 18.8%.

In comparison with the balance at the end of 2012, all three most significant types of standard off-balance sheet items of banks declined so there are no significant changes in their structure. The greatest (nominally and relative) reduction was seen in guarantees, by HRK 1.1bn or 6.0%, so currently they account for less than a third of all bank off-balance sheet items. Credit lines and commitments again accounted for the largest share of total standard off-balance sheet items (42.6%), and that share even rose slightly, despite the 1.9% decrease in liabilities. Among other commitments banks most intensively reduced revolving loans (4.1%), which accounted for around 17.0% of all standard off-balance sheet items.

Derivative financial instruments

In accordance with International Accounting Standards the derivative financial assets and liabilities are classified as financial assets/liabilities at fair value through profit or loss, except when they are formed and effective as hedging instruments. Almost all instruments are distributed in the trading portfolio (more than 99%), although a part of the derivatives serves domestic banks as a hedge, primarily against currency and interest rate risks, so it may be linked to the hedge against economic risks. The remainder of the total derivative financial instruments referred to embedded derivatives, while a negligible part was reported as a hedging instrument. Hedge accounting[7] is not applied widely, due to the complexity and the public disclosure requirements, which complicates the analysis and interpretation of data referring to derivatives and the related financial result.

The banks often contract derivatives serving to hedge their own position with majority foreign owners, and they often close positions contracted on the account of clients with foreign owners (the so called back-to-back deals), which hedges them against market risk. Apart from that, derivatives are used for regulatory arbitrage, which is related to the rule on minimum foreign currency liquidity (minimum ratio of foreign currency liquid assets to foreign currency liabilities of 17%). Over the counter derivatives accounted for the majority of derivatives; they are traded directly between two parties, without intermediation on regulated markets, which makes them a source of credit risk or counterparty credit risk for banks.

After a decrease last year the contracted value of derivative financial instruments in the first half of 2013 grew dramatically (by HRK 42.6bn or 33.3%), and it stood at the record-high HRK 170.4bn. This resulted in the increase in the ratio of notional amount of derivative financial instruments to bank assets from 32.0% at the end of 2012 to 42.6% at the end of June 2013 (Figure 48). The greatest share of that increase was achieved through the increase in swaps (HRK 23.3bn or 19.8%) and forwards (HRK 19.5bn or 230.1%). The growth in cross-currency interest rate swaps concluded between one bank and the Ministry of Finance of the Republic of Croatia had a significant impact on the increase in derivative instruments. The amount of instruments contracted with pension funds and pension fund management companies, as well as the amount of instruments contracted between domestic banks also significantly rose.

Swaps retained a dominant share in the structure of total derivative financial instruments (82.7%)[8], despite the reduction in the share by 9.4 percentage points from the end of the previous year. This was due to a rather strong relative growth in forwards which doubled in the observed period and stood at 16.5% of all derivative financial instruments. Options and futures (which are traded on regulated markets) accounted for 0.6% each and other derivatives only 0.1%.

In the structure of derivative financial instruments observed by the type of the underlying variable, the greatest group of instruments was still the one with exchange rate as the underlying variable which accounts for 60.2% of all contracted derivative financial instruments. The so called combined instruments, that is, instruments with the exchange rate and interest rate as underlying variables, follow with the share of 25.3%, while the significance of instruments with interest rate as the underlying variable decreased by 4.7 percentage points, to 14.5%.

7 Hedge accounting recognises the effects of netting profit or loss from changes in fair value of the hedging instrument and the hedged item.
8 In the last quarter of 2012 one bank moved a considerable amount of foreign exchange forwards to cross-currency interest rate swaps, which significantly changed the structure of derivative financial instruments.

Table 8 Bank income statement
in million HRK

	Jan.–Jun. 2012	Jan.–Jun. 2013
Continuing operations		
Interest income	10,896.2	9,805.1
Interest expenses	5,439.8	4,874.8
Net interest income	5,456.4	4,930.3
Income from fees and commissions	2,015.2	2,004.4
Expenses on fees and commissions	612.1	600.7
Net income from fees and commissions	1,403.1	1,403.6
Income from equity investments	156.8	346.4
Gains (losses)	841.4	314.9
Other operating income	197.6	205.1
Other operating expenses	324.5	324.7
Net other non-interest income	871.2	541.6
Total operating income	7,730.7	6,875.6
General administrative expenses and depreciation	3,960.3	3,772.0
Net operating income before loss provisions	3,770.4	3,103.6
Expenses on value adjustments and provisions	1,636.3	1,840.2
Other gains (losses)	0.0	0.0
Income (loss) from continuing operations, before taxes	2,134.1	1,263.3
Income tax on continuing operations	365.2	281.2
Income (loss) from continuing operations, after taxes	1,768.9	982.1
Discontinued operations		
Income (loss) from discontinued operations, after taxes	6.5	4.2
Current year profit/loss	1,775.5	986.3
Memo item:		
Number of banks operating with losses	11	11

Source: CNB.

Derivative financial instruments with all other underlying variables (indices etc.) had very low shares.

11.1.3 Earnings

Income statement

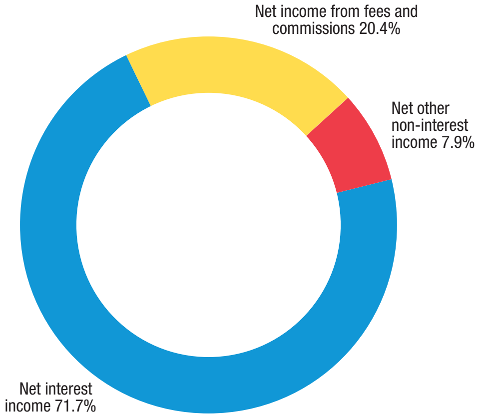
At the end of the first half of 2013, the banks generated HRK 1.3bn in profit (from continuing operations, before tax), which is a decrease in profit of HRK 870.8m or 40.8% from the end of the same period in the previous year (Table 8). The fall in bank profit was mostly due to a fall in interest income from loans, mainly fuelled by a fall in income from loans to corporates. Banks also reported a fall in net other non-interest income which, combined with the fall in interest income led to a fall in operating income, while an additional negative influence on bank profit came from a considerable increase in expenses for loss provisions.

Only five banks reported a rise in profits from the same period of the previous year, while eleven banks accounting for 11.3% of bank assets operated with losses amounting to HRK 216.9m. The number of banks operating with losses did not change, but the total amount of losses rose by 66.5% from the first half of 2012.

Interest income had the biggest nominal impact on the fall in profit, having fallen by a total of HRK 1.1bn (10.0%) from the first half of the previous year in most banks. Income from interest on loans fell more sharply (HRK 1.3bn or 13.86%) than total interest income with this fall being partly mitigated by increased interest income from financial assets intended for trading and held-to-maturity assets. The fall in interest income from loans was mainly due to deteriorating credit portfolio quality. Poor credit activity generated few new claims, while in the existing portfolio there was a rising level of loans with uncertain collection of interest income, which generally cannot be recognised in the profit and loss account before it is collected. Lower financing costs of banks abroad were crucial for the fall in total interest expenses (HRK 565.1m or 10.4%) with the final result of developments in interest income and expenses being a fall in net interest income of HRK 526.0m or 9.6% from the same period in the previous year.

Compared to the first half of 2012, only derivatives held-for-trading and securities, mainly bills of exchange which are held to maturity by banks, reported an increase in interest income. Despite the relative significance of the increase in interest income from these instruments, in total terms it stood at HRK 350.1m and only mitigated the fall in total interest income. The developments in interest income were mostly driven by a fall in income from all types of loans, except income from overdraft facilities and to a lesser extent income from Lombard loans and financial leasing. The biggest nominal decline came in interest income from loans for working capital (HRK 305.5m or 17.6%). Contributions to the fall in interest income

Figure 50 Structure of bank operating income
as at 30 June 2013



Source: CNB.

came from almost all institutional sectors but particularly from the corporate sector, where the banks reported a fall of HRK 903.7m or 26.6% in interest income from loans from the same period in the previous year. Almost half of that amount went to income from loans for working capital, the quality of which continued to deteriorate throughout the year, resulting in a 28.4% smaller interest income from these loans. Interest income from investment loans to corporates also fell considerably (23.2%). The quality of these loans deteriorated and so did the amount of loans granted. The next biggest contribution to the fall in interest income came from all types of household loans. In this loan category, the banks reported a fall in income of a total of HRK 222.1m (4.6%) from the same period 2012. Car loans and home loans accounted for the bulk of this fall with interest income from these loans falling by HRK 56.0m or 32.2% and HRK 53.3m or 3.2%, respectively. The main reason for the fall in interest income from car purchase loans was a continuous fall in the amount of loans granted, i.e. the amount of loan repayments, while in the case of home loans, the main reason for the fall in interest income was a fall in their quality and insecurity as regards the collection of interest income.

Interest expenses fell as a result of strong deleveraging efforts of banks on the foreign market, present since the second half of 2012 until the first quarter of this year. This process came to a halt in the second quarter of 2013, and its effects in the profit and loss account at the end of the first half of the year were seen in a considerable decline in bank financing costs with foreign financial institutions. Of the total decline in interest expenses on deposits, loans received and other financial liabilities, which amounted to HRK 813.4m (16.0%), foreign financial institutions accounted for 656.1m, down 41.2% from the same period in the previous year. The remaining part of the decline went to expenses on the sources from other institutional sectors except household deposits for which the banks had to allocate a slightly higher amount of expenses (0.8%) than in the same period of 2012. As the average expense on household deposits remained unchanged, the increase in expenses was based on the increase in the base.

Income from fees and commissions fell slightly (HRK 10.8m or 0.5%) while expenses on fees and commissions fell by a slightly higher HRK 11.3m or 1.9%. As a result, income from fees and commissions remained almost unchanged and had no influence on developments in bank profit. Smaller income from fees and commissions for banking services, particularly from households, as well as smaller expenses of banks in the payment system, had the biggest impact on changes in these items. The banks again generated the bulk or almost 41.1% of income from fees and commissions from payment services, this type of income continuing to grow slightly (0.3%). Households are the most significant source of income from fees and commissions for the banks, accounting for 36.4% of this income at the end of the first half of this year.

Net other non-interest income fell by HRK 329.7m or 37.8% from the end of the same period in the previous year. This fall was due to a fall in other non-interest income, as a result of losses generated by banks through sale of loans and receivables, currency and debt instrument trading and losses on financial assets measured at fair value. The negative impact of the fall in gains on net other non-interest income was mitigated by increased income from equity investment and stagnation in other operating expenses.

As a result, the operating income of banks fell by HRK 855.2m or 11.1% relative to the same period in 2012. Further savings generated by banks in general administrative expenses and depreciation of HRK 188.3m (a decline of 4.8%) could not substantially offset the negative effect of fall in operating income on bank profit.

The described developments in the net income that makes up operating income led to small changes in the structure of operating income of banks, with the fall in other non-interest income having the biggest impact. The share of this component in operating income declined from the same period in the previous year by 3.4 percentage points, more to the benefit of an increase in the share of net income from commissions and fees (2.3 percentage points) than to an increase in the share of net interest income (1.1 percentage point).

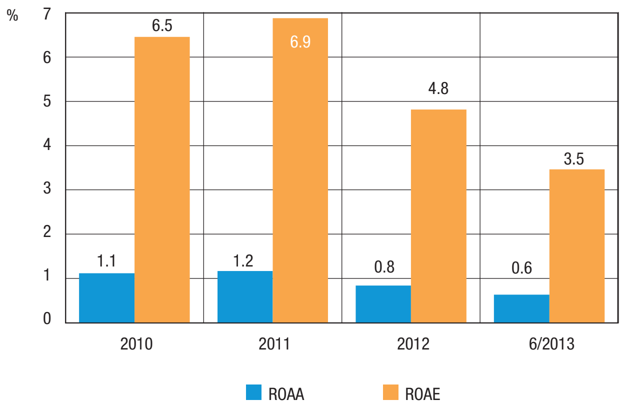
The fall in the operating income was coupled by a considerable increase in total value adjustments and loan loss provisions (HRK 203.9m or 12.5%). The banks used 26.8% of their operating income for their allocation, an increase of almost six percentage points from the same period in the previous year. The fall in credit portfolio quality and a sharp growth in value adjustment costs for risk category B-1, B-2, B-3 and C[9] had a key impact on expenses growth (HRK 293.1m or 17.8%) and this involved in particular loans for working capital and home loans. Due to a fall in risk category A placements, the repealed collectively assessed impairment provisions for latent losses in this category generated HRK 53.4m in income for the banks, 30.5% lower than the income generated in the year before. Increased costs for expenses on provisions for court proceedings pending against the banks and the costs of many other provisions which totalled HRK 21.0m had a minor impact on the growth in total loss provisions.

Indicators of returns

Considerably poorer business results undermined the profitability of banks and cut the ROAA and ROAE in half from the

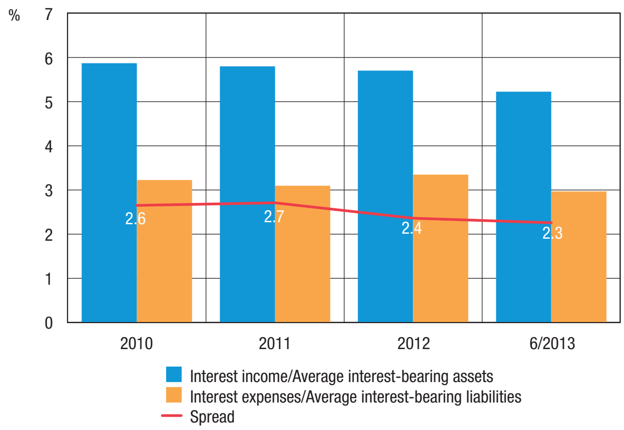
9 Placements and off-balance sheet liabilities are distributed into risk categories A, B-1, B-2, B-3 and C. Fully recoverable placements and off-balance sheet liabilities are distributed into risk category A; partly recoverable placements and off-balance sheet liabilities are distributed into risk categories B-1, B-2 and B-3, while fully irrecoverable placements and off-balance sheet liabilities are distributed into risk category C.

Figure 51 Bank return on average assets (ROAA) and bank return on average equity (ROAE)



Source: CNB.

Figure 52 Income from interest-bearing assets and expenses on interest-bearing liabilities



Source: CNB.

first six months of the previous year. ROAA fell from 1.1% to 0.6% and ROAE fell from 6.3% to 3.5% (Figure 50).

Further weakening of the ability of assets of banks to generate income was also reflected in the fall in interest income by unit of average interest-bearing asset. At the end of the first half of 2013, yield generated by average asset unit was 5.2%, down 0.5 percentage points from the end of the first half of the previous year. Despite a concomitant fall in interest expenses, the interest rate spread shrank to 2.3% (Figure 51).

The fall in banks' cost-to-income ratio is also reflected in increased need for the use of operating income for the coverage of general administrative expenses and depreciation compared to the end of the same period of 2012. Despite the fact that the banks generated savings on these costs in the first half of 2013, lower earnings drove their cost-to-income ratio on total bank level up from the previous year's 51.2% to 54.9%.

The reduction in the number of employees made it possible for the banks to cut employee expenses in the first half of 2013 by 3.9%, which accounted for almost one half of the reduction in general administrative expenses of banks. Staff reductions in the conditions of asset stagnation led to a very small increase in the average amount of assets managed per employee, from HRK 18.5m at the end of 2012 to HRK 18.7m at the end of the first half of 2013.

11.1.4 Credit risk

Placements and assumed off-balance sheet liabilities

Total placements and assumed off-balance sheet liabilities that are exposed to credit risk[10] and are subject to classification into risk categories in accordance with the rules that govern classification, stood at HRK 421.6bn (Table 9) at the end of June 2013, down HRK 0.4bn or 0.1% from the end of 2012. Such a small change can be attributed to somewhat more pronounced but mutually opposite developments of individual items in the structure of total placements and off-balance sheet

Table 9 Classification of bank placements and assumed off-balance sheet liabilities by risk categories

end of period, in million HRK and %

Risk category	Dec. 2011			Dec. 2012			Jun. 2013		
	Placements and assumed off-balance sheet liabilities	Value adjustments and provisions	Coverage	Placements and assumed off-balance sheet liabilities	Value adjustments and provisions	Coverage	Placements and assumed off-balance sheet liabilities	Value adjustments and provisions	Coverage
A	398,369.0	3,600.3	0.9	378,979.1	3,418.1	0.9	374,694.7	3,364.7	0.9
B-1	16,731.9	2,341.9	14.0	18,812.4	2,608.7	13.9	20,938.3	3,051.6	14.6
B-2	13,909.9	6,173.1	44.4	13,703.7	6,346.6	46.3	14,705.7	6,764.4	46.0
B-3	1,854.0	1,486.9	80.2	2,839.8	2,290.3	80.6	3,469.9	2,804.1	80.8
C	6,852.2	6,852.2	100.0	7,630.9	7,629.7	100.0	7,790.5	7,785.3	99.9
Total	437,716.9	20,454.4	4.7	421,965.9	22,293.4	5.3	421,599.0	23,770.1	5.6

Source: CNB.

10 Total 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.

liabilities, such as the increase in loans granted, investments in securities and other claims and a reduction in off-balance sheet liabilities and given deposits.

With banks remaining cautious as regards risk assumption, slow credit activity in the first half of 2013 resulted in HRK 2.5bn or 0.9% increase in the amount of loans (gross) granted from the end of 2012. The increase in loans mostly involved loans to the corporate sector and government units, while the household sector continued to deleverage. The banks continued to reduce assumed liabilities towards clients in all sectors, except the central government, thus reducing their total exposure based on off-balance sheet liabilities by HRK 1.8bn or 3.3% relative to the end of 2012. The bulk of this reduction could be attributed to guarantees and lines of credit and other commitments for financing large corporates in the public enterprise subsector. As a result, assumed liabilities to that subsector were reduced by a total of HRK 1.4bn or 20.1%.

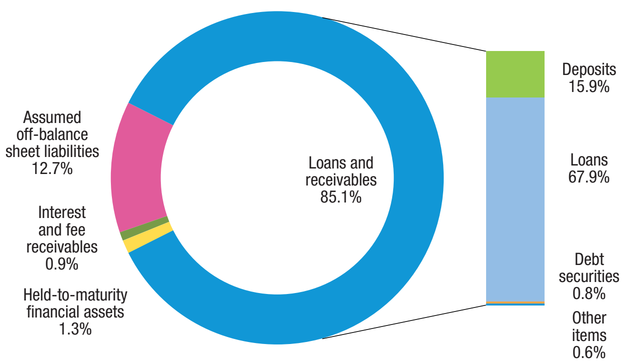
Calculated from the end of 2012, the banks reduced the amount of deposits made by HRK 1.6bn or 2.3%. The decline almost entirely involved deposits with foreign financial institutions and was partly alleviated by increased deposits with the CNB, mainly as a result of an increase in banks' settlement accounts. Debt securities of banks distributed in the portfolio of loans and receivables and the held-to-maturity portfolio rose by a total of HRK 370.4m or 4.5% from the end of 2012. This was mostly due to an increase in bank investments (9.9%) in bills of exchange.

The fall in deposits and off-balance sheet liabilities, which are typically of better quality compared to loans granted, and the growth in risk categories B and C loans led to deterioration in the quality of total placements and off-balance sheet liabilities. The share of risk category A in total placements and assumed off-balance sheet liabilities fell by almost one percentage point to 88.9% while 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 liabilities (risk category C) rose to a total of 11.1%. In the past five years, marked by economic crisis and low credit activity, the share of irrecoverable placements and off-balance sheet liabilities in total rose by over three times.

The total loss on portfolios exposed to credit risk at the end of June 2013 reached 5.6% of placements and off-balance sheet liabilities (Table 9). Collectively assessed value adjustments and provisions fell only slightly, but owing to a simultaneous fall in the base, the coverage of risk category A remained at the usual level of 0.9%. Risk category A placements and off-balance sheet liabilities fell in the first half of 2013 by HRK 4.3bn or 1.1%. The bulk of this decline can be attributed to deterioration in the quality of these receivables, i.e. to the reclassification of A category placements and off-balance sheet liabilities into worse risk categories, as a result of which B[11] and C risk category placements and off-balance sheet liabilities rose by a total of HRK 3.9bn or 9.1% from the end of 2012. The growth rate of value adjustments and provisions for B and C categories in the first half of 2013 was a little slower than the growth rate of their base (8.1%), which led to a small fall in the coverage of loans in this risk category; from 43.9% at the end of 2012 to 43.5%.

More difficult collection of banks' claims was also reflected in faster dynamics of growth in due but unpaid receivables.

Figure 53 Structure of bank placements and assumed off-balance sheet liabilities
as at 30 June 2013



Source: CNB.

Until end-June 2013, due but unpaid receivables grew by HRK 3.9bn or 13.3%, a much faster growth compared to that in the whole of 2012. Slow collection processes can particularly be associated with the age structure of due receivables and growth of long-overdue receivables. Of the total of HRK 33.0bn in due but unpaid receivables by placements, as much as HRK 20.1bn were overdue for over one year. The main reason for the growth in total due receivables were loans for working capital which accounted for over 40% of the total amount of increase in due receivables.

In contrast with negligible developments in total placements and off-balance sheet liabilities, the currency structure underwent a more significant change, the result being a smaller exposure to currency-induced credit risk. The net value of total placements and off-balance sheet liabilities granted in a foreign currency or indexed to a foreign currency fell by HRK 9.9bn or 3.9% from the end of 2012, fully as a result of liabilities not hedged against currency-induced credit risk. This was mostly due to a fall in currency-indexed home loans and off-balance sheet liabilities of clients with unmatched currency positions. By contrast, the net value of total placements and off-balance sheet liabilities in kuna rose during that period (HRK 8.0bn or 5.3%), mostly as a result of growth in loans for working capital and cash general-purpose loans. At the end of 2013, such developments resulted in a decline in the share of total placement and off-balance sheet liabilities exposed to currency-induced credit risk in the total, from 63.0% at the end of 2012 to 60.8%, while as regards loans, this indicator fell from 76.1% to 73.7%. The bulk of loans (89.8%) continued to be unhedged against this risk, having been placed to clients with an unmatched currency position.

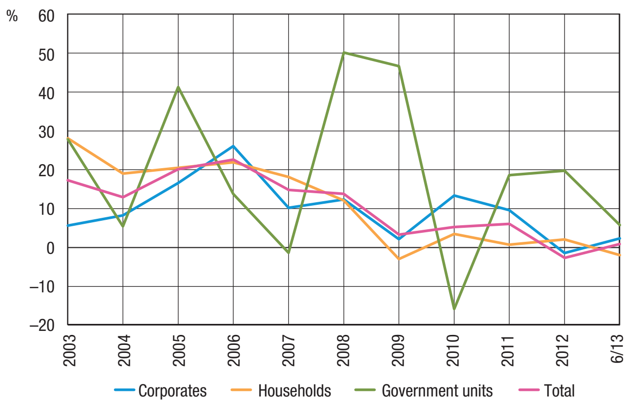
Loans

Although there was a very small nominal growth rate in loans[12] (0.9%), their growth rate with exchange rate effects excluded was a little faster and stood at 2.0% at the end of the first half of 2013. The difference between nominal and effective growth was mostly influenced by the strengthening of the exchange rate of the kuna against the euro which halved

11 Risk categories B-1, B-2 and B-3

12 In gross amount.

Figure 54 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.

the growth rate of euro loans (including those with a currency clause). In addition to the increase in euro loans (2.6%, with the exchange rate effects excluded), the banks also increased the amount of loans granted in kuna (4.1%) while loans in Swiss francs and other less represented major currencies continued to fall. However, the increase in new loans was not sufficient to halt deterioration of the credit portfolio with the share of loans classified into risk categories B and C rising from 13.9% at the end of 2012 to 15.1% at the end of June 2013.

The first half of the year saw an increase in loans to all sectors, except the household sector, which continued to reduce its liabilities towards the banks. The bulk of the increase in loans involved loans granted to corporates (HRK 2.6bn or 2.4%) and government units (HRK 2.2bn or 5.8%). Loans to public enterprises rose somewhat faster in relative terms (3.9%) than loans to other corporates (2.0%), although the latter rose faster in absolute amount (HRK 1.8bn). The amount of loans to corporates in the first half of the year was influenced to a degree by further realisation of banks' loans to the CBRD in the context of the Economic Development Programme. At the end of June, these loans amounted to HRK 1.2bn. Loans to the financial institutions sector rose by 6.8% while those to non-residents, due to their low base, rose by a relatively high 18.1%.

Unlike the previous years when it was largely driven by a fall in car loans, household deleveraging, present for five years, was in the first half of 2013 mostly influenced by a fall in home loans . Household loans fell by a total of HRK 2.5bn (2.0%) in the first six months of the year and with the exchange rate effects excluded, they fell by a lower 0.6%.

The absence of faster recovery in credit activity and continued unfavourable economic developments led to a further deterioration in loan quality indicators. As the amount of newly-granted loans was not sufficient to make up for regular loan repayments and migration of liabilities into worse risk categories, risk category A loans declined by 0.5%. B and C category loans rose by 9.4% from the end of 2012 mostly as a result of developments in loans to corporates. The increase in corporate risk category B and C loans was sharper than the average and stood at 10.3%, while the share of these loans rose from 25.0% at the end of 2012 to 26.9% of the total loans to corporates at the end of June 2013. Household B and C category loans rose by 6.7%, thus contributing to further loan quality deterioration in the household sector which involved all types of loans, particularly home loans.

The dynamics of increase in loans estimated by banks as partly or fully irrecoverable was followed by a somewhat slower growth rate in value adjustments (8.0%). The level of coverage of total B and C category loans by value adjustments fell slightly from the end of 2012 and stood at 42.0% at end-July. The level of coverage of total loans again benefited from a typically better coverage of B and C household loans (54.5%) than corporate loans (36.5%), although the fall in total coverage during the observed period was due to a small fall in household loan coverage.

The exchange rate effects excluded, the growth in corporate loans in the first half of 2013 stood at 3.3%, while the structure of corporate debt increase again indicates that the greatest need is for working capital financing. Loan increase in that sector was also propelled by syndicated lending, while other more significant types of loans, such as investment loans, construction loans, loans for agriculture and export financing fell in amounts that ranged from slight to considerable. The most widely represented form of corporate lending was loans for working capital, which accounted for 37.7% of total loans to corporates. Investment loans accounted for the next largest share, or 25.1% while syndicated loans accounted for 11.2%.

If we exclude the increase in loans to the central government, which, in the structure of loans observed by activity, is visible in the growth of loans to public administration and defence (6.8%), the next largest nominal increase in loans was in manufacturing (HRK 0.8bn or 3.5%). The increase in loans to that industry involved mainly loans to the activity of manufacture of refined petroleum products, while loans to most other activities included in manufacturing fell. More significant increases in loans, partly of seasonal character, were reported in the activity of food preparation industry and food services, transport and storage and trade. A small increase in loans of HRK 247.9m or 0.8% was also reported in construction, but primarily as a result of an increase in loans to one public enterprise involved in construction and management of motorways. After households, the most significant activity in the credit portfolio of banks was construction which accounted for 11.3% of total loans. This share remained unchanged from the end of 2012, while further deterioration in the quality of loans to that activity led to its increased share in the distribution of total B and C category loans (18.3%).

After households, the biggest contribution to the increase in total B and C loans in the first half of the year came from the trade activity where B and C loans rose by HRK 781.3m or 15.0%. After construction, trade was the next activity in terms of share in the distribution of total B and C loans. The share of these loans in this activity accounted for 27.7% of total loans. The increase in B and C loans to the construction activity was a little smaller (HRK 710.1m or 9.9%) so the share of these loans in total loans to the construction activity rose to 24.4%. The bulk of deterioration in construction loans involved loans to companies involved in the construction of residential and non-residential buildings where the share of B and C loans grew to over one half of the total amount of loans. The riskiest activity at the end of June 2013, with the biggest share of partly recoverable and fully irrecoverable loans, was the activity of professional, scientific, technical, administrative and ancillary services (44.0%) which also reported a considerable growth

Table 10 Bank loans

end of period, in million HRK and %

	Dec. 2011		Dec. 2012			Jun. 2013		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
Loans								
Government units	32,722.6	11.2	37,720.1	13.3	15.3	39,894.6	13.9	5.8
Corporates	121,716.9	41.7	107,997.5	38.0	–11.3	110,548.6	38.6	2.4
Working capital loans	45,655.1	15.7	39,728.8	14.0	–13.0	41,668.8	14.5	4.9
Investment loans	32,545.1	11.2	28,497.7	10.0	–12.4	27,765.1	9.7	–2.6
Shares in syndicated loans	10,590.3	3.6	11,134.8	3.9	5.1	12,397.1	4.3	11.3
Construction loans	5,666.2	1.9	5,326.9	1.9	–6.0	5,213.5	1.8	–2.1
Other corporate loans	27,260.3	9.3	23,309.2	8.2	–14.5	23,504.1	8.2	0.8
Households	128,057.8	43.9	126,198.0	44.5	–1.5	123,729.7	43.2	–2.0
Home loans	59,642.3	20.4	59,235.9	20.9	–0.7	57,370.5	20.0	–3.1
Mortgage loans	3,261.3	1.1	3,073.7	1.1	–5.8	2,910.9	1.0	–5.3
Car loans	4,539.4	1.6	3,174.9	1.1	–30.1	2,552.4	0.9	–19.6
Credit card loans	4,109.3	1.4	3,941.2	1.4	–4.1	3,912.9	1.4	–0.7
Overdraft facilities	8,196.0	2.8	8,611.7	3.0	5.1	8,426.9	2.9	–2.1
General-purpose cash loans	36,284.4	12.4	36,436.4	12.8	0.4	36,948.2	12.9	1.4
Other household loans	12,025.1	4.1	11,724.3	4.1	–2.5	11,607.9	4.1	–1.0
Other sectors	9,219.5	3.2	11,990.1	4.2	30.1	12,257.2	4.3	2.2
Total	291,716.9	100.0	283,905.6	100.0	–2.7	286,430.1	100.0	0.9
Partly recoverable and fully irrecoverable loans								
Government units	97.4	0.3	68.2	0.2	–30.0	44.3	0.1	–35.0
Corporates	24,744.7	68.2	26,952.3	68.1	8.9	29,731.2	68.7	10.3
Working capital loans	7,763.2	21.4	10,327.7	26.1	33.0	11,790.2	27.2	14.2
Investment loans	6,416.5	17.7	6,914.9	17.5	7.8	7,437.4	17.2	7.6
Shares in syndicated loans	162.1	0.4	120.8	0.3	–25.5	243.1	0.6	101.3
Construction loans	3,165.3	8.7	3,489.5	8.8	10.2	3,649.7	8.4	4.6
Other corporate loans	7,237.6	20.0	6,099.4	15.4	–15.7	6,610.8	15.3	8.4
Households	11,020.9	30.4	11,977.6	30.3	8.7	12,784.7	29.5	6.7
Home loans	3,111.4	8.6	3,654.2	9.2	17.4	4,058.2	9.4	11.1
Mortgage loans	699.8	1.9	732.7	1.9	4.7	743.7	1.7	1.5
Car loans	181.5	0.5	157.7	0.4	–13.1	114.3	0.3	–27.5
Credit card loans	164.3	0.5	174.8	0.4	6.4	176.9	0.4	1.2
Overdraft facilities	1,298.8	3.6	1,280.5	3.2	–1.4	1,265.2	2.9	–1.2
General-purpose cash loans	3,052.2	8.4	3,297.5	8.3	8.0	3,542.7	8.2	7.4
Other household loans	2,512.9	6.9	2,680.2	6.8	6.7	2,883.8	6.7	7.6
Other sectors	411.5	1.1	552.3	1.4	34.2	716.1	1.7	29.7
Total	36,274.5	100.0	39,550.4	100.0	9.0	43,276.3	100.0	9.4
Value adjustments of partly recoverable and fully irrecoverable loans								
Government units	19.8	0.1	25.4	0.2	28.6	13.2	0.1	–47.9
Corporates	8,687.7	57.8	9,812.1	58.3	12.9	10,843.7	59.7	10.5
Working capital loans	2,986.1	19.9	3,684.3	21.9	23.4	4,287.0	23.6	16.4
Investment loans	2,123.2	14.1	2,180.9	13.0	2.7	2,282.0	12.6	4.6
Shares in syndicated loans	51.6	0.3	51.7	0.3	0.2	81.2	0.4	57.0
Construction loans	962.9	6.4	1,335.8	7.9	38.7	1,428.5	7.9	6.9
Other corporate loans	2,564.0	17.1	2,559.4	15.2	–0.2	2,764.9	15.2	8.0
Households	6,059.2	40.3	6,690.5	39.7	10.4	6,970.0	38.4	4.2
Home loans	1,040.3	6.9	1,257.3	7.5	20.9	1,397.2	7.7	11.1
Mortgage loans	185.1	1.2	213.8	1.3	15.5	225.0	1.2	5.2
Car loans	138.9	0.9	124.9	0.7	–10.1	90.3	0.5	–27.7
Credit card loans	147.9	1.0	161.2	1.0	9.0	164.3	0.9	1.9
Overdraft facilities	1,204.6	8.0	1,205.3	7.2	0.1	1,197.5	6.6	–0.6
General-purpose cash loans	2,224.7	14.8	2,455.3	14.6	10.4	2,582.4	14.2	5.2
Other household loans	1,117.7	7.4	1,272.7	7.6	13.9	1,313.2	7.2	3.2
Other sectors	262.6	1.7	305.2	1.8	16.2	346.2	1.9	13.4
Total	15,029.2	100.0	16,833.1	100.0	12.0	18,173.1	100.0	8.0

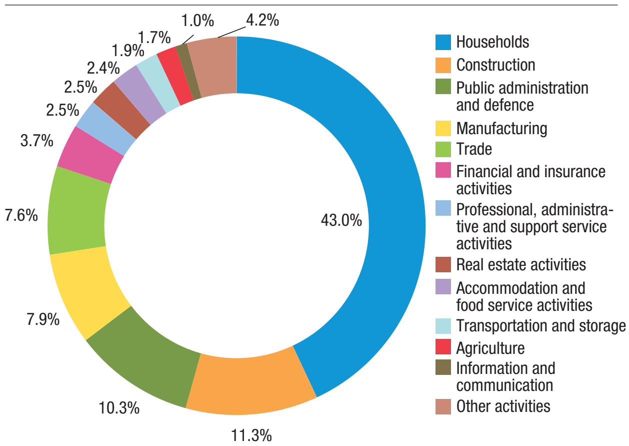
Source: CNB.

in irrecoverable loans. In all the three mentioned activities, the coverage of B and C loans by value adjustments was equal to the average coverage in the corporate loans category.

A fall in loans in the household sector was the result of a fall in all major types of loans except cash general-purpose loans, but the key impact on total developments came from a fall in home loans of almost HRK 1.9bn or 3.2%. The change in the amount of home loans was largely driven by exchange rate developments that caused the rate of fall in these loans to multiply by a factor of almost three. The exchange rate effects excluded, home loans fell by 1.2% with the exception of euro-indexed loans, which rose by 0.5%. Swiss-franc indexed loans fell the most, both in terms of the amount and the rate of fall. If the exchange rate effects are excluded, they fell by HRK 761.6m or 3.3%.

In terms of the structure of household loans, there are three dominant types of loans, which at the end of the first half of 2013 accounted for over 83.0% of the total loans to households. The leading type of loans, accounting for 46.4% of total household loans, is again home loans, followed by cash general-purpose loans, which have gained in significance and reached almost 30% of household loans. Loans based on overdraft facilities came next, but they accounted for a much lower share (6.8%).

Figure 55 Structure of bank loans by activities
as at 30 June 2013



Source: CNB.

Deterioration in the quality of household loans continued into the first half of 2013, and the share of risk categories B and C in total household loans rose from 9.5% at the end of 2012 for the first time to over 10% of the total household loans (10.3%) (Figure 56). The fall in the quality of household loans was mostly due to deterioration in the quality of home loans, which accounted for one half of the total growth in B and C loans. B and C category home loans thus rose by HRK 404.0m or 11.1%, reaching 7.1% of the total home loans. The increase in B and C loans indexed to the Swiss franc to 10.8% had the biggest impact on this change. In relative terms, B and C category home loans indexed to the euro rose faster than those indexed to the Swiss franc. However, the quality of the euro-indexed part of the portfolio of home loans was still much better, with the share of partly recoverable and fully irrecoverable loans standing at 4.2%.

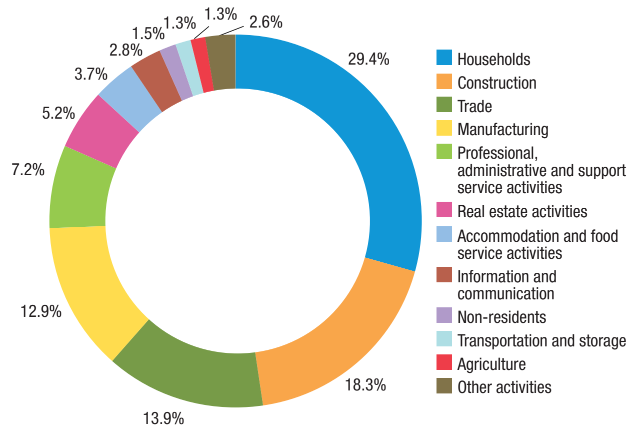
In addition to home loans, deterioration in the quality of household loans was also driven by developments in cash general-purpose loans which had 9.6% of B and C category loans. Car loans, credit card loans and Lombard loans maintained a better quality than home loans (4.5%, 4.5% and 5.2% respectively). However, all the three mentioned types of loans combined account for only 6.3% of the total household loans and do not have a very big impact on the total quality of loan portfolio in that sector.

11.1.5 Capital adequacy

The capital adequacy ratio of banks stood at 20.8% (Figure 57) at the end of June 2013, a small decline from 20.9% at the end of 2012. The fall in the rate was the result of a fall in own funds (HRK 640.5m or 1.2%), mainly due to the smaller amount of hybrid instruments included in additional own funds. A small fall in total capital requirements (HRK 218m or 0.7%) only mitigated the impact of a fall in own funds on developments in the adequacy ratio.

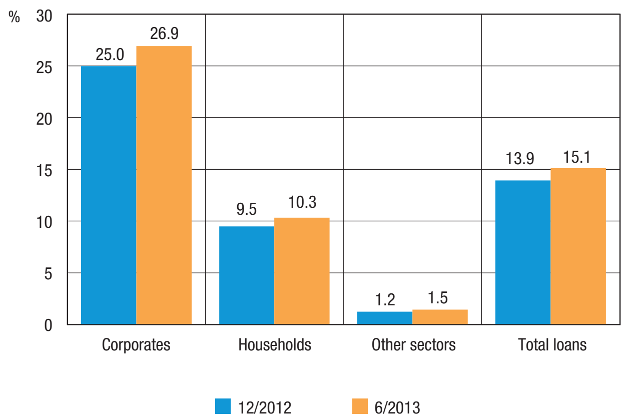
In two banks, the capital adequacy ratio was lower than the prescribed minimum (12%), due to operating losses which

Figure 56 Structure of bank partly recoverable and fully irrecoverable loans by activities
as at 30 June 2013



Source: CNB.

Figure 57 Share of bank partly recoverable and fully irrecoverable loans



Source: CNB.

reduced their own funds. In nine banks, the capital adequacy ratio stood between 12% and 15%, and in ten banks it stood between 15% and 20% and above 20% (Table 13).

Own funds of banks stood at HRK 55.2bn at the end of the first half of 2013. The biggest contribution to the fall in own funds from the end of 2012 came from a fall in additional own funds of HRK 541.6m or 15.9%. The fall in additional own funds is due to a lower amount of hybrid and subordinated instruments which may be included in the calculation of own funds.

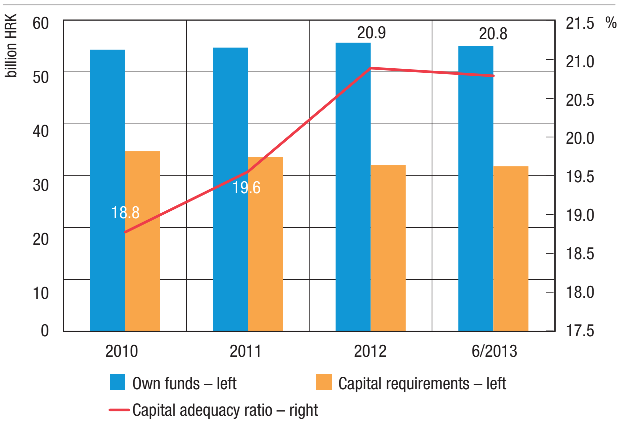
A high balance sheet capital to liabilities ratio, coupled with a high capital adequacy of original own funds bespeaks good capital quality of banks. Original own funds comprise ordinary and non-cumulative preferential shares, retained earnings and reserves and after deductions, their share in own funds at the end of the first half of 2013 stood at 94.8%. Additional own funds, net of deductions, accounted for only 5.2% of own funds, and their share in own funds continued to trend downwards. The increase in deduction items, and in particular a greater shortfall in provisions under the IRB approach. had a negative impact on the level of own funds.

The reduction in the capital requirement for credit risk, counterparty risk, dilution risk and free delivery risk (hereinafter: capital requirement for credit risk) of HRK 185.0m or 0.7% was of lower intensity than in the previous year, and was mostly the result of a reduction in net exposure weighted for credit risk, which suggests that banks remain cautious as regards risk assumption. The amount of net exposure that is weighted fell by HRK 2.0bn (0.5%) from the end of 2012, primarily as a result of a fall in balance sheet items. The average weight for credit risk continued to trend downwards and stood at 56.2% at the end of June 2013.

To calculate the capital requirement for credit risk almost all banks use the standardised approach, except one bank which has CNB permission to use the IRB approach. Accordingly, 86.0% of the total exposure for capital requirement for credit risk was thus calculated using the standardised approach, with the amount of net exposure weighted under the standardised approach falling by 0.6%. The fall in the institutions and households categories had the biggest impact on the fall in the exposure. Under the IRB approach, exposure rose by 0.4% as a result of increase in exposure in the central government and central bank category.

The average weight for credit risk under the standardised approach rose very slightly and stood at 58.2%. Compared to the standardised approach, under the IRB approach the average weight was rather low, primarily as a result of a much lower average weight for the household category, which stood at 40.5% under the IRB approach and at 87.4% under the standardised approach. The growth in the average weight under the standardised approach is the result of a fall in the share of exposures weighted by a 20% weight, mostly involving exposures

Figure 58 Bank capital adequacy ratio



Source: CNB.

Table 11 Own funds, capital requirements and capital adequacy ratio of banks
as at 30 June 2013, in million HRK and %

	Amount	Share
Own funds	55,159.8	100.0
Original own funds	54,473.3	98.8
Paid up capital (excl. cumulative preferential shares) net of own shares	34,131.7	61.9
Reserves and retained earnings	20,937.1	38.0
Other	–595.4	–1.1
Additional own funds	3,564.6	6.5
Paid-up cumulative preferential shares	0.0	0.0
Hybrid and subordinated instruments	3,578.7	6.5
Other	–14.1	0.0
Items deducted from original own funds and additional own funds	–2,878.2	–5.2
Capital requirements	31,835.8	100.0
Credit, counterparty credit and dilution risks and free deliveries	28,018.7	88.0
Standardised approach	24,938.5	78.3
Corporates	10,824.1	34.0
o/w: Secured by real estate property	98.7	0.3
Retail	11,692.4	36.7
o/w: Secured by real estate property	495.2	1.6
Other	2,421.9	7.6
IRB approach	3,080.2	9.7
Corporates	1,661.5	5.2
Retail	875.9	2.8
Settlement/delivery risks	0.0	0.0
Position, foreign exchange and commodity risks	627.9	2.0
o/w: Internal models	0.0	0.0
Traded debt instruments	395.0	1.2
Foreign exchange	169.2	0.5
Other risks	63.8	0.2
Risk of exceeding the permitted exposure limits	0.0	0.0
Operational risk	3,189.3	10.0
Simplified approach	402.2	1.3
Standardised approach	1,468.2	4.6
Advanced measurement approach	1,318.9	4.1
Surplus/deficit of own funds	23,323.9	–
Capital adequacy ratio	20.8	–

Source: CNB.

in the institutions category and exposures weighted by a 50% weight (equally in the central government and central banks categories and institutions) and growth in the share of exposures with 100% and 150% weights. Exposures weighted by a 100% weight rose the most in the corporate category. The share of the high risk-weight of 150 rose slightly, particularly in the retail category. Due but unpaid receivables with a 100% weight (value adjustments higher than 20% of the unsecured part of the total exposure) rose by 16.3%.

In addition to the reduction in the capital requirement for credit risk, all other components of the capital requirement also decreased slightly. The capital requirement for market risk thus fell by 0.1% and those for operational risk by 1.0%. The share of the capital requirement for credit risk in the total capital

Table 12 Breakdown of net exposure to credit risk by risk weights
as at 30 June 2013, 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	111,511.3	88,622.2	109,267.8	20,081.5	6,717.4	3,065.0	534.5	17,181.1	–	356,980.8
On-balance sheet items	107,846.4	73,711.6	107,907.6	17,214.2	5,807.6	2,964.9	534.5	16,767.4	–	332,754.1
Off-balance sheet items	3,664.6	13,760.7	657.0	600.2	519.1	100.1	0.0	143.7	–	19,445.5
Securities transactions and long settlement transactions	0.0	613.4	6.4	651.9	196.7	0.0	0.0	270.0	–	1,738.4
Derivative financial instruments	0.2	536.5	696.8	1,615.3	194.0	0.0	0.0	0.0	–	3,042.8
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	106,861.1	5.0	4,254.5	0.0	0.0	8,411.5	–	119,532.1
Weight 10%	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	–	0.2
Weight 20%	0.0	22.8	16.4	12,743.8	18.6	349.9	11.5	431.4	–	13,594.5
Weight 35% (residential real estate property)	11,421.8	439.6	0.0	0.0	0.0	0.0	0.0	5.8	–	11,867.2
Weight 50%	258.6	1,337.0	1,234.1	6,136.7	2,312.9	2,711.5	4.0	0.3	–	13,995.1
o/w: Commercial real estate property	258.6	1,336.9	0.0	0.0	0.0	0.0	0.0	0.0	–	1,595.5
Weight 75%	33,295.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	–	33,295.5
Weight 100%	62,929.1	81,510.8	1,154.3	1,187.1	79.9	2.1	411.7	8,194.6	–	155,469.6
o/w: Past due items	3,058.3	6,498.4	0.0	0.4	0.0	0.9	0.1	12.6	–	9,570.7
Weight 150%	3,606.2	5,181.3	2.0	8.9	51.5	1.5	41.9	42.1	–	8,935.4
o/w: Past due items	3,028.6	4,160.3	1.2	7.2	51.5	1.5	0.0	33.8	–	7,284.1
Other risk weights	0.0	130.8	0.0	0.0	0.0	0.0	65.3	95.1	–	291.2
Credit risk mitigation techniques – substitution effects										
Total outflow	–1,195.4	–5,816.6	0.0	–274.2	–18,492.2	–30.8	–28.5	–101.3	–	–25,939.1
Total inflow	6.6	183.7	20,648.7	467.1	90.5	519.2	0.0	1,527.3	–	23,443.2
IRB APPROACH										
Total exposure	18,013.2	17,857.0	19,952.3	2,244.9	–	–	–	–	117.9	58,185.3
On-balance sheet items	17,606.2	16,347.2	19,579.8	1,839.8	–	–	–	–	117.9	55,490.9
Off-balance sheet items	406.1	1,369.8	372.5	11.1	–	–	–	–	–	2,159.6
Securities transactions and long settlement transactions	0.0	72.0	0.0	41.0	–	–	–	–	–	113.0
Derivative financial instruments	0.8	68.0	0.0	353.1	–	–	–	–	–	421.9
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	–161.8	0.0	0.0	–	–	–	–	0.0	–161.8
Total inflow	0.0	0.0	2,644.6	13.1	–	–	–	–	0.0	2,657.7

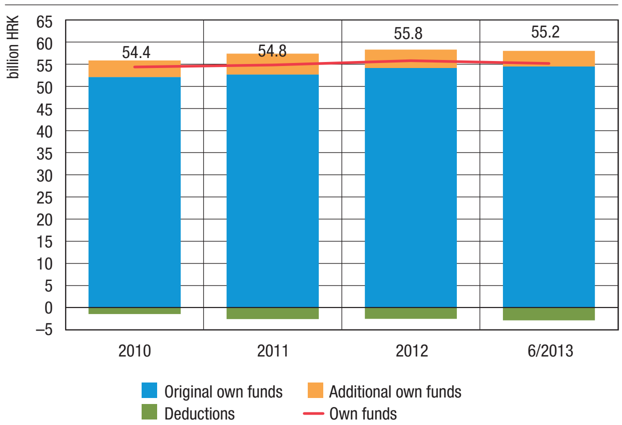
Source: CNB.

Table 13 Breakdown of bank capital adequacy ratio
end of period, in %

	Dec. 2011		Dec. 2012		Jul. 2013	
	Number of banks	Share in bank assets	Number of banks	Share in bank assets	Number of banks	Share in bank assets
Ratio lower than 12%	1	0.5	2	0.3	2	0.8
Ratio from 12% to 15%	9	9.5	7	7.1	9	8.3
Ratio from 15% to 20%	13	34.6	12	37.5	10	36.4
Ratio higher than 20%	9	55.4	10	55.1	10	54.6

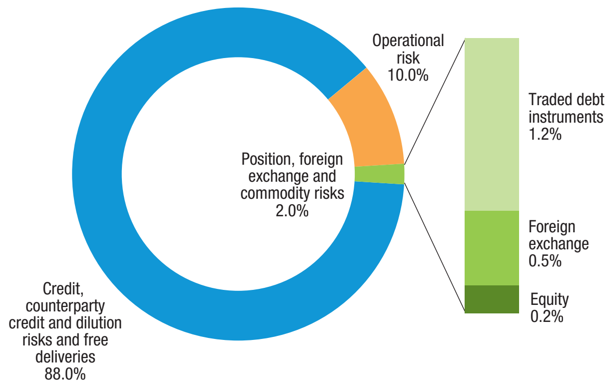
Source: CNB.

Figure 59 Bank own funds



Source: CNB.

Figure 60 Structure of bank total capital requirements
as at 30 June 2013



Source: CNB.

requirement stood at 88.0% (Figure 59), while the share of the capital requirement for operational risks remained almost unchanged and stood at 10.0% of the total capital requirement. The capital requirement for market risks again accounted for a small share in the total capital requirement of only 2.0%, with the largest share going to the capital requirement for the position risk of debt instruments (1.2% of the total capital requirements).

Not a single bank used the internal approach to calculate the capital requirement for market risks. The banks calculated the bulk of the capital requirement for operational risk using the standardised approach. Six banks used this approach. Two 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.

11.2 Housing savings banks

At the end of the first half of 2013, there were five housing savings banks operating in the territory of the Republic of Croatia, the ownership structure of which remained unchanged from the end of the previous year. One housing savings bank was in majority state ownership and the remaining four were in the direct or indirect majority ownership of foreign shareholders.

The total assets of housing savings banks stood at HRK 7.2bn, a decline of 2.9% or 1.9% with the exchange rate effects excluded, from the end of 2012. The share of assets of housing savings banks held steady at 1.8% of the total assets of the system. The fall in housing savings banks assets during the observed period was the result of a fall in the sources of financing, i.e. deposits of housing saving banks savers.

All housing savings banks reported a fall in assets during the reporting period, ranging from 1.2% to 9.8%. The intensity of the fall in assets of the only savings bank in domestic ownership reduced its market share by 0.3 percentage points to 4.1%. This reinforced the already dominant share of assets of housing savings banks in majority foreign ownership to 95.9% of the total assets of all housing savings banks. Three housing savings banks were in direct or indirect majority ownership of Austrian shareholders and at the end of June 2013, their assets accounted for 76.0% of total housing savings bank assets. Assets of one housing savings bank in the indirect majority ownership of Italian shareholders accounted for 19.9% of the total assets of all housing savings banks.

At the end of the first half of 2013, housing savings banks had 376 employees, 8.1% fewer than at the end of 2012. The fall in the number of employees resulted in an increase in assets managed per housing savings bank employee. At the end of the first half of 2013, the average amount of assets per employee was HRK 19.3m, which was higher than the same indicator for the banks.

11.2.1 Balance sheet

The assets of housing savings banks have held steady since end-2008, i.e. since the beginning of the crisis. The only exception was a considerable increase in assets, which took place in 2011, primarily as a result of adjustments of housing savings banks to the provisions of the Decision on the management of interest rate risk in the non-trading book[13]. As housing savings are characterised by a short cycle of up to five years compared to the average duration of home loans, the savings banks were significantly exposed to interest rate risk in the non-trading book. They attempted to reduce this exposure by increasing long-term sources (mostly from parent banks). The sources purchased for this purpose started falling sharply towards the end of that year, and particularly during 2012, owing to the use of the adjusted models for the calculation of exposure to interest rate risk in the non-trading book[14].

The reason for the fall in assets in the first half of the year was the fall in the savings of housing savings bank savers of almost 4.0%. Even though housing savings typically grow the most towards the end of the year, the reason for the diminished appeal of this type of savings might lie in state incentives having been slashed from 15% to 10% earlier this year[15]. To finance this outflow, the savings banks reduced investments in deposits with financial institutions and increased indebtedness based on loans received from domestic banks.

The resulting fall in deposits with domestic credit institutions of HRK 118.8m or 16.4% was the biggest change in the assets of housing savings banks compared to the end of 2012. In terms of the amount of change, only other asset items stand out. The developments in these items (and by analogy, liabilities) are the result of regular calculation of government incentives, i.e. the closing of receivables from the Ministry of Finance and the execution of the payment obligation towards housing savings banks savers. Investments in securities and net loans granted in the first half of 2013 changed only slightly. The portfolio of securities investments rose by 0.5% due to an increase in investments in bonds of the Republic of Croatia (3.7%), in contrast with investments in T-bills of the Ministry of Finance, which fell (10.4%). 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. Credit activity of housing savings banks did not recover in the first half of the year; quite to the contrary, net loans fell by 0.6%. In terms of the currency structure of loans granted, except less significant kuna loans, the housing savings banks only have loans with a currency clause in the euro, so if the effect of exchange rates is excluded, loans grew by a small 0.6%.

Only three housing savings banks reported an increase in net loans (one of them reported an extraordinarily high growth of 56.9%), but only in one of them was this increase the result of an increase in home loans. In the remaining two housing savings banks, loans to public enterprises were the only item that grew, while in terms of exposure to public enterprises one housing savings bank stood out in particular. At the end of the first half of 2013, home loans granted by housing savings banks stood at HRK 3.5bn (net), accounting for 5.9% of the total home loans of all credit institutions.

The fall in housing savings banks liabilities reflects the already mentioned fall in deposits of housing savings banks savers of 4.0% (2.7% if the exchange rate effects are excluded), to a little below HRK 6.1bn. In the first half of 2013, all housing savings banks reported a decline in this basic source of financing ranging from 2.5% to 9.7%. Housing savings banks savers provide the sole source of deposits of housing savings banks. At the end of the first half of 2013, their deposits accounted for 96.3% of the total sources of financing. A little over one half

Table 14 Structure of housing savings bank assets
end of period, in million HRK and %

	Dec. 2011		Dec. 2012			Jul. 2013		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
Money assets and deposits with the CNB	0.0	0.0	0.0	0.0	–41.7	0.0	0.0	50.0
Money assets	0.0	0.0	0.0	0.0	–41.7	0.0	0.0	50.0
Deposits with the CNB	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Deposits with banking institutions	669.7	8.5	723.1	9.7	8.0	604.3	8.3	–16.4
MoF treasury bills and CNB bills	668.1	8.5	594.1	8.0	–11.1	532.0	7.3	–10.4
Securities	2,394.4	30.5	2,056.4	27.6	–14.1	2,131.4	29.4	3.6
Derivative financial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	3,777.2	48.1	3,767.6	50.5	–0.3	3,745.9	51.7	–0.6
Loans to financial institutions	90.9	1.2	69.3	0.9	–23.8	0.0	0.0	–100.0
Loans to other clients	3,686.3	47.0	3,698.3	49.6	0.3	3,745.9	51.7	1.3
Investments in subsidiaries, associates and joint ventures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreclosed and repossessed assets	0.0	0.0	0.2	0.0	–	0.2	0.0	0.0
Tangible assets (net of depreciation)	5.7	0.1	5.3	0.1	–6.4	4.6	0.1	–14.3
Interest, fees and other assets	387.4	4.9	363.5	4.9	–6.2	271.8	3.8	–25.2
Net of: Collectively assessed impairment provisions	56.1	0.7	54.1	0.7	–3.6	51.2	0.7	–5.3
TOTAL ASSETS	7,846.5	100.0	7,456.1	100.0	–5.0	7,239.0	100.0	–2.9

Source: CNB.

13 OG 2/2010, 34/2010 and 37/2012.
14 Such models are based on the inclusion of the effects of renewal of housing savings banks' contracts and their use reduces the need for long-term sources of financing.
15 The Act on Housing Savings and State Incentives for Housing Savings (OG 109/1997, 117/1997, 76/1999, 10/2001, 92/2005, 21/2010 and 15/2013).

Table 15 Structure of housing savings bank liabilities and capital

end of period, in million HRK and %

	Dec. 2011		Dec. 2012			Jul. 2013		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
Loans from financial institutions	458.9	5.8	0.0	0.0	–100.0	57.4	0.8	100.0
Short-term loans	172.8	2.2	0.0	0.0	–100.0	57.4	0.8	100.0
Long-term loans	286.2	3.6	0.0	0.0	–100.0	0.0	0.0	0.0
Deposits	6,345.1	80.9	6,344.9	85.1	0.0	6,094.3	84.2	–3.9
Transaction account deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Savings deposits	154.1	2.0	160.7	2.2	4.3	121.8	1.7	–24.2
Time deposits	6,191.0	78.9	6,184.1	82.9	–0.1	5,972.5	82.5	–3.4
Other loans	94.1	1.2	94.3	1.3	0.2	93.1	1.3	–1.2
Short-term loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term loans	94.1	1.2	94.3	1.3	0.2	93.1	1.3	–1.2
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
Debt securities issued	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
Long-term debt securities issued	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
Hybrid instruments issued	97.7	1.2	97.8	1.3	0.1	87.1	1.2	–10.9
Interest, fees and other liabilities	368.3	4.7	345.5	4.6	–6.2	322.3	4.5	–6.7
Total liabilities	7,364.1	93.9	6,882.4	92.3	–6.5	6,654.2	91.9	–3.3
Share capital	487.9	6.2	487.9	6.5	0.0	487.9	6.7	0.0
Current year profit/loss	10.6	0.1	67.5	0.9	538.3	16.0	0.2	–76.3
Retained earnings/loss	15.0	0.2	25.1	0.3	67.2	91.1	1.3	262.6
Legal reserves	6.2	0.1	6.7	0.1	7.6	8.2	0.1	22.8
Reserves provided for by the articles of association and other capital reserves	9.2	0.1	3.6	0.0	–61.1	4.8	0.1	35.9
Revaluation reserves	–46.5	–0.6	–17.1	–0.2	–63.3	–23.2	–0.3	35.8
Previous year profit/loss	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total capital	482.4	6.1	573.7	7.7	18.9	584.8	8.1	1.9
Total liabilities and capital	7,846.5	100.0	7,456.1	100.0	–5.0	7,239.0	100.0	–2.9

Source: CNB.

of the total amount of deposits (57.5%) was placed to housing savings banks savers in the form of home loans. Despite the home loans to housing savings ratio being the highest ever, it grew very modestly over the past five years.

Housing savings banks did not rely much on hybrid and subordinated instruments as a source of financing. Only two housing savings banks used hybrid instruments and one housing savings bank stopped using these instruments this year. At the end of June 2013, one housing savings bank used these instruments which are normally used by credit institutions as additional own funds to meet the capital adequacy requirements, to cover a portion of the significant losses from the previous periods.

Housing savings banks generated a record current year profit at the end of 2012, (HRK 67.5m)[16] The housing savings banks distributed the entire amount of this profit in the first half of 2013 into retained earnings or used it to cover losses brought forward, thus boosting these balance sheet items. However, due to much poorer business results in the first six months of this year and an increase in unrealised losses on value adjustments of financial assets available for sale, the total balance sheet capital of savings banks rose by only 1.9%. The share of capital in the assets of housing savings banks thus rose by only 0.4 percentage points, reaching 8.1%, much below the bank average. In two housing savings banks that use hybrid instruments as additional own funds, the share of capital in assets ranged only slightly above 5.0%.

11.2.2 Income statement

At the end of the first half of 2013, housing savings banks generated HRK 20.1m in (pre-tax) profit from continuing operations, a reduction of over 47.4% from the same period in the previous year (Table 16). The significant fall in profit was primarily the result of a fall in income from securities

16 At the end of 2012, all savings banks operated with profit before taxes but after calculating the taxes, one housing savings banks reported a current year loss (after taxes).

investments of housing savings banks compared to the same period of 2012. The housing savings banks mitigated the negative effect of these developments by generating savings on the side of general administrative expenses and depreciation and smaller interest expenses on the sources of financing. At the end of the first half of 2013, two housing savings banks had operated with a loss totalling HRK 1.5m.

In contrast with banks, interest income from housing savings banks loans fell only slightly (1.3%), with the fall in total interest income of HRK 16.8m or 9.2% being predominantly attributable to a fall in interest income from securities. Interest income from securities fell by HRK 16.5m (22.0%) and together with losses from securities trading and losses on fair value adjustment through profit and loss, at the end of the first half of this year, the housing savings banks generated HRK 32.5m or 37.9% less profit from securities investments than in the same period in the previous year. A small decline in interest income from loans was attributable almost entirely to interest income deriving from participation of housing savings banks in syndicated lending, while interest income from home loans rose slightly (1.4%).

Interest expenses of housing savings banks fell by 9.1% compared to the first half of 2012 as a result of a fall in the sources of financing of housing savings banks, which are almost exclusively deposits of housing savings banks savers. As a result, interest expenses on received deposits were down 5.3% with a somewhat smaller contribution to this fall in interest expenses coming from a relatively significant decline in these expenses on received loans (60.2%). The described developments in interest income and interest expenses resulted in a lower net interest income (HRK 7.1m or 9.3%) than at the end of the same period 2012.

Net income from fees and commissions rose by only 0.8%, mainly as a result of cuts in expenses, and had a very small impact on changes in the operating income of housing savings banks. The biggest contribution to the fall in operating income and profit of housing savings banks in the first half of 2013 in nominal terms came from net other non-interest income which, in contrast with the profit generated in the same period in the previous year, stood at a negative HRK 14.7m. Such a result at the end of the first half of 2013 was due to losses from securities trading (HRK 6.2m), a fall in other operating income (16.6%) and operating expenses which, owing to their nature (deposit insurance premium), fell only slightly (2.2%).

The developments in net income of housing savings banks resulted in a fall in total operating income of 22.5%. The fall in profit was also influenced by charges for value adjustments and provisions, deriving mainly from a small deterioration in the quality of home loans.

The significant fall in profit in the first half of 2013 led to a considerable deterioration in the profitability of housing savings banks. ROAA fell from 1.1% at the end of the first half of 2012 to below 0.6% at the end of June 2013, while ROAE fell from 13.1% to 5.5% during the same period. Despite their considerable decline (13.0%) from the year before, general administrative expenses and depreciation put a bigger pressure on housing savings banks earnings, as evidenced in a significant increase in their share in operating income, from 66.5% to 74.7%.

Table 16 Housing savings bank income statement
in million HRK

	Jan. – Jun. 2012	Jan. – Jun. 2013
Continuing operations		
Interest income	183,3	166,5
Interest expenses	106,4	96,8
Net interest income	76,8	69,7
Income from fees and commissions	32,7	32,8
Expenses on fees and commissions	4,8	4,6
Net income from fees and commissions	28,0	28,2
Income from equity investments	0,0	0,0
Gains (losses)	10,6	–6,2
Other operating income	3,9	3,3
Other operating expenses	12,0	11,8
Net other non-interest income	2,5	–14,7
Total operating income	107,3	83,1
General administrative expenses and depreciation	71,4	62,1
Net operating income before loss provisions	35,9	21,0
Expenses on value adjustments and provisions	–2,3	0,9
Other gains (losses)	0,0	0,0
Income (loss) from continuing operations, before taxes	38,2	20,1
Income tax on continuing operations	5,3	4,3
Income (loss) from continuing operations, after taxes	32,8	15,8
Discontinued operations		
Income (loss) from discontinued operations, after taxes	0,2	0,2
Current year profit/loss	33,0	16,0

Source: CNB.

11.2.3 Credit risk

The balance and off-balance sheet items of housing savings banks exposed to credit risk stood at HRK 5.9bn at the end of the first half of 2013, down 2.4% from the end of 2012. The fall in total placements was mainly due to a fall in deposits made which also influenced the fall in risk category A placements (Table 17). At the end of the first half of 2013, 84.4% of the total housing savings banks' capital requirements went to cover credit risk.

Credit risk was again low in housing savings banks, which can be attributed to a high share of total placements and assumed off-balance sheet liabilities classified in the highest-quality A risk category (99.3%). The remaining 0.7% of placements and assumed off-balance sheet liabilities were classified in B and C risk categories. B and C risk category placements and assumed off-balance sheet liabilities rose by 21.6% from the end of 2012 due to deterioration in the quality of home loans portfolio. At the end of June 2013, the share of B and C loans in total loans rose slightly, but stood again at a low 1.0%.

In addition to overall credit portfolio quality, the quality of home loans in housing savings banks was much better than in banks, as seen in a low share of B and C category home loans in total loans (1.1%). The type of currency did not play a big role in this share, with kuna loans and kuna loans with a currency clause in the euro accounting for almost equal shares of B and C home loans in total loans at the first half of 2013

Table 17 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. 2011		Dec. 2012			Jun. 2013		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
A	6,423.0	99.5	5,979.0	99.5	–6.9	5,830.1	99.3	–2.5
B-1, B-2 and B-3	27.8	0.4	29.7	0.5	6.7	36.1	0.6	21.5
C	2.0	0.0	2.7	0.0	31.5	3.3	0.1	21.7
Total	6,452.9	100.0	6,011.4	100.0	–6.8	5,869.4	100.0	–2.4

Source: CNB.

Table 18 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. 2011	Dec. 2012	Jul. 2013
Total value adjustments against placements and provisions for assumed off-balance sheet liabilities	62.3	61.2	59.7
Value adjustments and provisions	5.9	6.7	8.0
Collectively assessed value adjustments and provisions	56.4	54.5	51.7
Total placements and assumed off-balance sheet liabilities	6,452.9	6,011.4	5,869.4
Coverage	1.0	1.0	1.0

Source: CNB.

(1.0% and 1.1%, respectively). The share of over 90 days past due receivables in the structure of total housing savings banks loans was negligible.

Value adjustments and provisions for B and C category placements rose slightly from the end of 2012. However, since total placements and off-balance sheet liabilities of housing savings banks are mostly classified as risk category A, the bulk of total value adjustments and provisions again involved collectively assessed impairment provisions. The amount of provisions for risk category A placements was down 5.1% from the end of 2012, as a result of a fall in risk category A placements. Compared to the end of the previous year, the coverage of total placements by value adjustments and provisions held steady at 1.0% (Table 18) while the coverage of B and C risk category loans fell slightly, from 19.9% to 19.7%.

11.2.4 Capital adequacy

The capital adequacy ratio of housing savings banks stood at 21.3% at the end of the first half of 2013, the same level as at the end of the previous year. This was due to an increase in the capital requirement of HRK 4.0m or 1.1% and an increase in own funds of HRK 6.7m or 1.1% of equal strength. The increase in own funds was almost entirely due to reserves and retained earnings from previous years, while the increase in the capital requirement was mainly the result of increase in the capital requirement for credit risk (2.6%), in particular in household lending. The average weight for credit risk rose slightly to 35.3% as a result, but was again much lower than in the case of banks. Other capital requirements of housing savings banks decreased from the end of 2012, thus alleviating the increase in the total capital requirement.

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
CHF	– Swiss franc
CHY	– Yuan Renminbi
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
JPY	– Japanese yen
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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