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Staff Country Reports

Republic of Croatia: Report on the Observance of Standards and Codes—Banking Supervision, Payment Systems, and Securities Regulation—Update

This update to the Report on the Observance of Standards and Codes on Banking Supervision, Payment Systems, and Securities Regulation for the Republic of Croatia was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on July 16, 2004. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the Republic of Croatia or the Executive Board of the IMF.

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REPUBLIC OF CROATIA

**Report on the Observance of Standards and Codes
Republic of Croatia—Banking Supervision, Payment Systems, and Securities
Regulation: Factual Update**

Prepared by the European and Monetary and Financial Systems Departments

Approved by Carlo Cottarelli and Robert J. Corker

July 16, 2004

This report, prepared in the context of the 2004 Article IV consultation, provides factual updates on material recent developments with respect to observance of international standards in Croatia in the areas of banking supervision, payment systems, and securities regulation since the 2001 joint IMF-World Bank Financial Sector Assessment Program (FSAP) mission. For a full description of institutions and practices, it should be read in conjunction with the original report, *Republic of Croatia—Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Banking Supervision, Payments System, Securities Regulation, Insurance Regulation, and Monetary and Financial Policy Transparency* (IMF Country Report No. 02/180, 08/02). The original report is available at <http://www.imf.org/external/pubs/ft/scr/2002/cr02180.pdf>.

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ABBREVIATIONS AND ACRONYMS

ATM	Automated Teller Machine
BCP	Basel Core Principles for Effective Banking Supervision
CBA	Croatian Banking Association
CNB	Croatian National Bank
CP	Core Principle
CPSS	Committee on Payment and Settlement Systems
CROSEC	Croatian Securities Commission
DVP	Delivery versus Payment
EU	European Union
FINA	Financial Agency
FSAP	Financial Sector Assessment Program
HSVP	Croatian Large Value System
IAS	International Accounting Standards
IOSCO	International Organization of Securities Commissions
MOU	Memorandum of Understanding
NKS	National Clearing System
POS	Point of Service
ROSC	Report on the Observance of Standards and Codes
SDA	Securities Depository Agency
VSE	Varaždin Stock Exchange
ZSE	Zagreb Stock Exchange

I. OBSERVANCE OF BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

A. Summary of FSAP Conclusions

1. The 2001 Financial Sector Assessment Program (FSAP) mission assessed Croatia's compliance with the Basel Core Principles for Effective Banking Supervision (BCP). The resulting report suggested that most of the core principles were either observed or broadly observed, the main exception being cooperation with foreign supervisory agencies, which was not possible under the then-existing legal framework. The key recommendations of the FSAP were to implement consolidated supervision, introduce capital requirements for market and related risks, introduce options in the calculation of net open foreign exchange positions, provide explicit immunity to supervisory staff from legal prosecution for performing their duties in good faith, establish cooperation with foreign supervisory agencies, and strengthen domestic supervisory cooperation. The Croatian National Bank (CNB) representatives indicated that they were fully aware of the remaining weaknesses in the existing legal framework and practices.

2. The FSAP's BCP assessment was summarized in the Report on the Observance of Standards and Codes (ROSC) on banking supervision, issued in 2002. The ROSC was based on information up to September 2001 and therefore did not take into account the new Banking Law, which was passed shortly thereafter.

B. Factual Update of Material Recent Developments

3. Many of the recommendations for the regulatory and supervisory framework for banking supervision arising from the BCP assessment were addressed by the new Banking Law, which came into force in July 2002, and was followed by several by-laws (all the documents are available at the CNB's website at www.hnb.hr/propisi/epropisi.htm). The key changes introduced by the new law and the by-laws related to the legal immunity of supervisors, coverage of market risks in capital adequacy calculation, inclusion of options in net open foreign exchange positions, consolidated supervision of banks, and cooperation with foreign supervisory agencies. In addition, the CNB's bank supervision was reorganized to conduct on-site supervision more on a risk basis, and on-site supervisors started examining foreign exchange exposures of banks' borrowers in more detail.

Objectives, Autonomy, Powers, and Resources (CP 1)

- (i) *Legal immunity for supervisors.* The FSAP suggested that supervisory staff should be given explicit immunity from legal prosecution for performing their duties in good faith. This was addressed in the new banking law.

Licensing and Structure (CPs 2–5)

- (ii) A Licensing and Market Competition Department was set up as a part of the reorganization of the CNB's banking supervision.

Prudential Regulation and Requirements (CPs 6–15)

- (iii) *Capital adequacy.* One of the key FSAP recommendations was to cover market and related risks—in addition to credit risks—in the calculation of capital adequacy. The additional risks were introduced in the calculation by the new banking law, and implemented through a new by-law that came into effect in January 2004, after a period of preparations and testing both at the CNB and in the banking industry.
- (iv) *Measurement of net open positions in foreign exchange.* The FSAP recommended including options and asymmetrically indexed loan contracts and deposits in the calculation of net open positions in foreign exchange. In April 2003, a new definition of the net open position was introduced that includes options and asymmetrically indexed contracts. After the introduction of this measure, many banks exceeded the 20 percent regulatory limit on net open positions to capital. The regulation provided for an adjustment path for these banks, requiring that all banks comply with the 20 percent limit by the beginning of 2005 at the latest.
- (v) *Measurement of indirect foreign exchange risk.* The FSAP warned about the considerable uncertainty regarding the extent of the credit risk stemming from unhedged foreign-currency borrowing. A survey of foreign exchange exposures of banks' largest customers, conducted by the CNB in 2003, indicated that there might be gaps in banks' monitoring of this part of the credit risk. Following up on the results of the survey, the CNB started examining foreign exchange exposures of banks' borrowers in more detail as a part of on-site examinations.
- (vi) *Classification of claims.* Another new by-law supporting the new banking law introduced a new classification of banks' claims. This by-law, which became effective in January 2004, allows to classify loans by risk categories rather than by debtors, as was the case in the previous regulation. The regulation also adjusts the measurement of financial instruments and off-balance sheet contingent liabilities as per international accounting standards (IAS 39 and 37).
- (vii) *Additional reserves for general risks.* The by-law mentioned in the previous point also introduced a requirement for banks, growing certain groups of their assets and off-balance sheet contingent liabilities by more than 20 percent per year, to form from their profit and maintain additional reserves for general risks. These provisions are lower or zero for banks with higher capital adequacy ratios.
- (viii) *Foreign exchange liquidity regulation.* At the time of the FSAP, foreign exchange liquidity risk was regulated by a requirement that banks maintain at a minimum 53 percent of short-term foreign currency liabilities in short-term foreign currency claims. In January 2003, the requirement was lowered to 35 percent, but applied to a substantially extended base, and the coverage was to be maintained on a daily basis rather than on a monthly basis. The main reason for these changes was to close

loopholes in the previous regulation, in particular the possibility that banks comply with the ratio only on the last day of the month by taking on short-term loans abroad.

- (ix) *Country risk.* The FSAP argued that country risk should be given appropriate attention, as it will become more important in the future. The CNB has assessed banks' country risk and concluded that it is still negligible, even though it may need to be reassessed in the future, if Croatian banks become more active abroad.

Methods of Ongoing Supervision (CPs 16–20, 22)

- (x) *Organization of banking supervision on risk basis.* The CNB's Banking Supervision Area was reorganized in early 2004 so that it can conduct on-site supervision more on a risk basis (which was one of the key suggestions of the FSAP). The changes resulting from the reorganization include a greater specialization of the on-site officers on a particular area of banks' activities (e.g., credit risk), and an increased focus on operational risks. Together with organizational changes, banking supervision staffing was also strengthened.
- (xi) *Consolidated supervision.* The FSAP recommended that supervision be conducted on a consolidated basis. The new banking law introduced consolidated supervision of banking groups, and a supporting by-law was issued and came into force in mid-2003. There are currently four banking groups in Croatia to which the consolidated supervision applies: three with mother banks in Croatia and one holding company in Croatia. Off-site reports for consolidated groups are being received on semi-annual basis, with a lag of about four months.
- (xii) *Council of financial sector supervisors.* The FSAP recommended that coordination with other domestic regulators be conducted on a more regular basis. While passing the new banking law, the Parliament asked the supervisory agencies to consider a coordination mechanism, including the possibility of a unified supervisory agency. The agencies prepared a proposal to create a committee to meet on a monthly basis. The plans for a unified supervisory agency have been postponed, in line with FSAP's recommendations. In mid-2003, the Parliament asked the Ministry of Finance to establish a council of domestic financial supervisors, to improve supervisory coordination. The council has not met yet.

Information Requirements (CP 21)

- (xiii) No major material developments took place in this area since the FSAP. In the meantime, the supervisory data set was extended, and the communication between commercial banks and the CNB was enhanced by using a secure internet channel.

Cross-Border Banking (CPs 23–25)

- (xiv) *MOUs with foreign supervisors.* The new banking law provided the necessary legal background allowing for agreements with foreign supervisory agencies. In November 2003, the CNB signed a memorandum of understanding (MOU) with bank supervisors in Bosnia and Herzegovina (where the largest Croatian bank has a substantial market share). MOUs with Austria and Italy are being negotiated (banks owned by financial groups from these two countries play a major role in the Croatian banking market).

II. OBSERVANCE OF CPSS CORE PRINCIPLES FOR SYSTEMICALLY IMPORTANT PAYMENTS SYSTEMS

A. Summary of FSAP Conclusions

4. The FSAP's assessment of Committee on Payment and Settlement Systems (CPSS) Core Principles for Systemically Important Payment Systems focused on two systemically important payment systems—the Croatian Large Value System (HSVP) and the National Clearing System (NKS) for small-value transactions—which comprise the vast majority of payment transactions in Croatia. The report noted that there were other payment systems covering checks, debit and credit cards, and ATM and POS networks, but these operations were unlikely to be a source of systemic risk or cause widespread disruption to clearing and settlement of payments.

5. The CPSS assessors found that there is a strong body of law supporting the national payment system and giving the CNB a clear responsibility for payment systems. The HSVP was found to be a modern and well-performing system that uses international best practices, procedures, and technology. They thought that it would be feasible and useful to modify the HSVP design to support a fully-collateralized intra-day facility and real-time-delivery-versus-payment (DVP) for secondary market trading in government and central bank securities.

6. The low value NKS system was also found in compliance with international best practices, provided that secondary back-up sites are developed. The assessors noted that the then-planned implementation of payment system reforms would have major implications for the institutional and operational role of the Financial Agency (FINA).

7. The deficiencies were at that time recognized by the CNB and FINA, which indicated their intention to address them during the payment system reform.

B. Factual Update of Material Recent Developments

8. Major changes have taken place since the FSAP assessment in the payments area. However, some of the main FSAP recommendations in this area—such as the introduction of real-time-DVP—remain to be implemented.

9. A significant payment reform took place after the FSAP that involved the institutional framework, payment structure, and transmission. As part of the reform, the CNB's oversight role was strengthened, and the Domestic Payment system Law, was replaced by a new National Payment System Law and a set of new by-laws.

10. The new payment system law, unlike the previous one, brought the payment system within the exclusive authority of depository institutions. The CNB manages the accounts of banks and the government, whereas banks manage accounts of households and enterprises and conduct payment transactions across these accounts. Interbank payments are conducted through interbank systems, to which only banks have access. Non-banks institutions may perform payment operations only in the name and for the account of banks.

11. The role of FINA was changed with the adoption of the Law on FINA on December 14, 2001, which removed FINA's monopoly position and focused its role more on information technology support (particularly for the operation of the state treasury system, public revenue collection, and operating a register of payment orders and other registers), collecting and processing data on business entities and financial flows (for tax authorities, statistical office, securities supervisors, etc.), and providing on a commercial basis services to banks (e.g., receiving payment orders at FINA's branches, providing electronic information on balances during the day, archiving, data entry, network services) and the CNB (distribution and processing of cash). Discussions on the future role, structure, and possible privatization of some parts of FINA are ongoing.

12. In 2003, the CNB founded the National Payment System Committee, which includes representatives of the CNB, Ministry of Finance, commercial banks, Croatian Banking Association (CBA), and the Croatian Chamber of Commerce. It aims at solving open issues and standardizing of activities in the payment system. In May–June 2003, based on the CNB's earlier by-law on payment orders, the CBA published standardized domestic payment orders and relevant instruction documents.

13. The following list juxtaposes the main material developments in the payment system and the main issues identified in the CPSS ROSC prepared during the FSAP:

- (i) *Back-up facilities.* The FSAP recommended that both the HSVP and the NKS strengthen back-up facilities, including secondary site arrangements as soon as possible. Back-up facilities have been improved. Secondary site arrangements were implemented for the NKS (in Split), but not for the HSVP.
- (ii) *Better liquidity arrangements.* The FSAP argued for improvements in liquidity arrangements, including a fully collateralized intra-day liquidity facility for HSVP, and suitable DVP for securities in real time. An improvement in the framework for liquidity management was addressed in the HSVP by-law. However, the full collateralized intra-day facility has not been implemented and the issue of achieving a suitable form of DVP for securities markets transactions has not been resolved between the CNB and the securities depository (SDA).

- (iii) *Improving governance of the NKS.* The FSAP recommended a clear board and management structure for the NKS, separate from the payments bureau (ZAP). It also proposed discussions on the future role of ZAP. These recommendations were partly addressed by the new legislation, especially the law on FINA. The NKS is not a separate legal entity, but it is a separate organizational unit within FINA. Discussions on the future role, structure, and possible privatization of parts of FINA are ongoing.
- (iv) *CNB's organizational structure.* The CNB owns, operates, and oversees the RTGS system, which gives rise to potential issues of conflict of interest. The FSAP recommended improvements in CNB's organizational structure by clearly separating oversight responsibilities from operational responsibilities. The responsibilities were separated by formally placing the oversight responsibilities of the CNB payment systems with CNB's internal audit entity.
- (v) *Information disclosure.* The CPSS ROSC prepared in the FSAP recommended publishing a broader range of statistics on the payment system. This has not been implemented yet, even though the CNB has been preparing forms for compilation of payment system statistics based on Bank for International Settlements and European Union (EU) methodology.

III. OBSERVANCE OF IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION

A. Summary of FSAP Conclusions

14. The assessment of observance of the International Organization of Securities Commissions (IOSCO) Objectives and Principles of Securities Regulation in the FSAP indicated that there was a considerable room for improvement. The core findings pointed to the need for strengthening the powers of the Croatian Securities Commission (CROSEC), clarifying its procedures for inspection and surveillance, and improving coordination between the CROSEC and the Croatian National Bank (CNB).

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

16. With respect to the principles for market intermediaries, the assessors found that the shortcomings in prudential regulation are compounded by the lack of staff to perform on-site inspections of intermediaries. With respect to the principles for issuers, the definition of securities was assessed as vague and broad, while the issuance of commercial papers was found overregulated by the assessors.

B. Factual Update of Material Recent Developments

17. There has been a number of substantial changes in the securities market regulation since the FSAP. The most important development in the legal area was the enactment of the Securities Market Law and the Takeover Law in 2002. The main changes in the Securities Market Law included: (i) mandatory listing requirement for all public limited companies that issue shares in a public offering or have certain minimum size; (ii) allowing banks to conduct securities business; (iii) strengthening disclosure requirements; and (iv) strengthening supervisory powers of the CROSEC. The main changes introduced by the new Takeover Law include granting to CROSEC new supervisory powers relating to takeovers. In particular, the CROSEC has to approve announcements of takeover offers, receives a broader range of information and documents relating to takeovers, and has greater powers in conducting supervision of participants in the takeover procedure.

18. The stated reasons for the introduction of the mandatory listing requirement in the new Securities Market Law were to increase corporate governance and transparency practices in Croatian companies by adding another layer of public disclosure, and to increase liquidity in the market. The law requires that all public companies that issue shares in a public offering or have more than 100 shareholders and initial capital of more than HRK 30 million be listed in the quotation of public limited companies by July 2003. As a result, 233 companies became listed in the quotation of public limited companies, of which 113 at the Zagreb Stock Exchange (ZSE) and 120 at the Varaždin Stock Exchange (VSE). In terms of market capitalization, about 70 percent of the newly listed companies are at the ZSE and 30 percent at the VSE. The impact on market liquidity still remains to be seen.

19. The following list juxtaposes the material developments in securities regulation and the main areas for improvement identified by the IOSCO ROSC prepared during the FSAP:

- (i) *Clear definition of objectives of securities regulation.* The FSAP recommended that the law define clearly the objectives of securities regulation and clarify the definitions of basic concepts, such as securities and public offering. This was implemented in the new Securities Market Law.
- (ii) *Strengthening the authority of the supervisor.* The FSAP recommended that the law grant the CROSEC legal authority to take corrective measures. The new Securities Market Law indeed granted to the CROSEC more enforcement powers than the previous legislation. In particular, the CROSEC now has the power to withdraw a license from a broker. Also, the enforcement authority of the CROSEC was clarified and strengthened in terms of scope, appeal procedures, and legal immunity of enforcement officers. The new law has detailed provisions about inspection, investigation, and surveillance.
- (iii) *Enforcement.* The new powers were used to step up enforcement efforts. In 2003, the CROSEC revoked 12 licenses of brokerage companies and 9 licenses of brokers. It also sent to courts 8 criminal indictments and 52 other indictments. In 3 cases of

illegal acts or irregularities, the CROSEC used its own enforcement measures, such as ordering the SDA to prevent a brokerage company from managing the owner's securities account in the SDA.

- (iv) *Implementation and resources.* The FSAP recommended that the CROSEC be provided with adequate resources to properly execute its mandate. Even though the CROSEC has been stepping up its supervisory and enforcement efforts, as indicated above, it continues to have insufficient resources, reflecting its lack of budgetary independence. The insufficient resources lead, among other things, to continuing difficulty to retain qualified staff.
- (v) *Interpretation of laws.* The FSAP suggested that the CROSEC makes available to the public its interpretations of the law. The CROSEC's interpretations of laws—in particular the Securities Market Law and Takeover Law—have been published in Croatian on CROSEC's website (www.crosec.hr). An English version of the website is under construction.
- (vi) *Professional standards.* The FSAP recommended that professional standards of CROSEC staff be upgraded, including the introduction of clear guidelines concerning possession and trading of securities by staff and affiliated or related persons. The new Securities Market Law requires CROSEC commissioners, employees, and associates, their close relatives (defined in the law), and legal persons in which they have majority interest to publicly disclose within two days their purchases or sales of securities. The law also includes provisions banning CROSEC staff from providing advice on securities investment or trading.
- (vii) *Strengthening disclosures.* The FSAP suggested extending disclosure requirements to supplementary documents prepared in offering. It also suggested ensuring that information on major shareholders of companies, especially those of listed companies, is disclosed in a short period of time. This was generally addressed in the new Securities Market Law, which strengthened the disclosure requirements, and provided that the identity of 10 largest owners of any security be made accessible to the public (at www.sda.hr). Also, the FSAP proposed utilizing stock exchange systems as an effective venue for timely disclosures. This has been implemented in the rules of the stock exchanges, which make available to all members in the trading system information and facts that can influence the price and securities. The Securities Market Law gives to CROSEC the power to regulate the mode and content of these disclosures.
- (viii) *Securities business of banks.* The FSAP recommended reconsidering whether banks should be allowed to engage in securities business through an in-house department, and it argued that regulators should ensure that a proper internal control system is in place within a market intermediary. However, since the FSAP, banks were allowed to engage in securities business in-house. At end-2003, there were 30 brokerage companies and 14 banks authorized by the CROSEC to conduct transactions with securities. So far, the CROSEC has conducted only one on-site visit of a bank.

CROSEC's yearly plans of on-site visits envisage an increase in the supervisory activity in this area.

- (ix) *Supervisory cooperation.* The FSAP suggested addressing ambiguity surrounding bank secrecy requirements and enhancing information sharing mechanism with other supervisory agencies. This was clarified in the new Securities Market Law, which requires that CROSEC and other financial sector regulators in Croatia share relevant information among themselves, allows the CROSEC to co-operate and share information with similar institutions in EU member countries (but not other countries), and states that this exchange of information is not considered to be disclosure of confidential business information. The exchange of supervisory information reportedly takes place, but so far only on an ad-hoc basis. The authorities plan to institute a council of domestic supervisors, but it has not met yet.
- (x) *Collective investment schemes.* The FSAP recommended making certain that separate assets of an open-end fund would not be subject to claims against the investment company in the case of bankruptcy of the investment company. The FSAP also recommended requiring an arms-length relationship between an investment company and a depository bank, and incorporating a clearer definition of related parties. These issues were addressed in the new legislation, namely in amendments to the Law on Investment Funds.
- (xi) *Governance of the securities depository.* One of the key FSAP recommendations was to transfer the majority ownership of the Securities Depository Agency (SDA) to the private sector, especially market participants. However, this has not taken place and the SDA remains majority state owned.
- (xii) *Vinkulacija.* At the time of the FSAP, a provision in the company law allowed company statutes to require approval of the company prior to share transfers (*vinkulacija*). This was intended to give company managers sufficient authority to competently run their companies; however, it also gave rise to a number of cases of abuses of shareholder rights. For dematerialized shares, the new Securities Market Law removed *vinkulacija*.