

ECRA Housing Project
Financial Sector Analysis

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1 Introduction

1.1 Purpose of Report

The purpose of the Economic and Community Revitalization Activity (“ECRA”) housing project is to:

- Identify and assess potential opportunities for improving access to housing and market-oriented housing solutions in selected municipalities throughout Croatia.
- Develop program strategies.
- Prepare, promulgate and review subgrantee proposals to initiate activities under an ECRA Request for Applications (RFA) for PVOs and NGOs to undertake demonstration projects.

This report has been prepared as part of an initial assessment of the housing sector in Croatia. It will be provided to potential subgrantees for information purposes.

1.2 Summary of Findings

The key housing lenders in Croatia are the major commercial banks and the Croatian Bank for Reconstruction and Development. A Housing savings banks industry is being established based upon the German model. In future, housing savings banks may play a significant role in the housing lending market. In ECRA areas, regional banks are also important for housing lending. City and county governments also have the potential to stimulate housing lending through bond issues, guaranty mechanisms, or other means.

The ECRA communities, however, are too small to have active real estate markets or to attract much attention from bank lenders. They also have problems with land registries, making it difficult for both lenders and borrowers to use residential property as collateral for loans.

There is significant demand for housing lending and municipal bond financing within the Croatian financial markets. Local capital markets are under-developed, so the main type of investments available for financial intermediaries is Croatian government bonds. Banks, insurance companies, investment funds, and (in future) pension funds are highly interested in increasing their investments in safe domestic financial instruments other than those issued by the central government.

The financial sector is dominated by the commercial banks. The banking sector is largely controlled by a few big banks which are owned by foreign banks. Financially, commercial banks are generally profitable and well capitalized. Liquidity of the banking sector is publicly perceived as being quite high but, in fact, some indicators

show that banks are not excessively liquid. Housing savings banks are tiny and have not yet started to lend.

Banks are required to have at least HRK 40 million of capital and to maintain a capital adequacy ratio of 10 percent or higher (international norms require 8 percent). Reserve requirements, which do not apply to housing savings banks, are high but falling.

Banks' housing lending criteria are quite conservative. This is because foreclosure procedures are long and difficult. Thus, banks apply stringent procedures such as high collateral margins, and multiple co-debtors or guarantors. Nonetheless, as housing lending becomes more competitive, interest rates are declining and housing loans are available to a larger segment of the population.

When borrowers default on housing loans, banks focus on collecting from the debtor, do-debtor(s), or guarantor(s). They initiate foreclosure proceedings only as a last resort, knowing that because of problems with the courts the procedure is a slow and ineffective means of collection.

2 Key Housing Lending Institutions

2.1. Housing and Consumer Lenders

Today, the primary housing lending institutions in Croatia are:

- Commercial banks.
- Croatian Bank for Reconstruction and Development (“HBOR”).

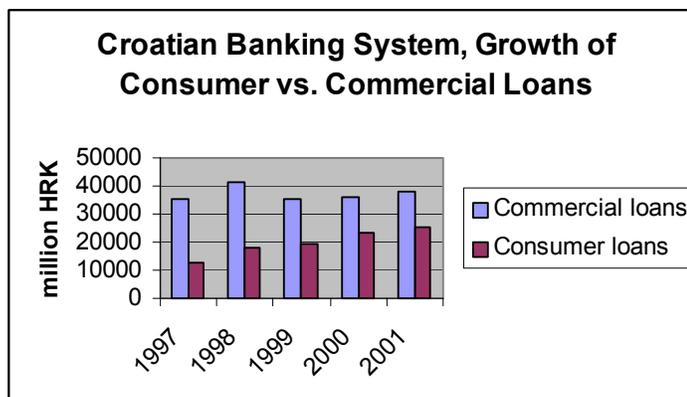
In future, housing lending could be stimulated by the following developments:

- The growth of housing savings banks.
- Municipal of county level programs such as bonds or guaranty mechanisms.

These issues are discussed in the following paragraphs.

Primary Housing Lenders Today.

Commercial banks are the primary source of lending to consumers for housing and other purposes. Financial and regulatory data about commercial banks is contained later in this report. Separate data is not available for housing loans, but lending to individuals represents a significant and growing portion of banks' loan portfolios, as shown below.



Note: Data for year 2001 is for the period ending March 31.¹

Banks With The Largest Consumer Loan Portfolios (Dec. 2000, HRK million)	Banks With Fastest Growing Consumer Loan Portfolios (Year 2000, growth rate and size of portfolio in HRK million)
Zagrebacka banka 6,421	Medimurska banka 213% 103
Privredna banka 3,710	Karlovacka banka 180% 28
Raiffeisenbank 1,370	Volksbank 132% 511
Splitska banka 1,318	Raiffeisenbank 75% 1,370
Rijecka banka 1,289	Hypo-Alpe-Adria Bank 68% 677

Source: Privredni Vjesnik, July 11, 2001.

There are no regulations or limitations on banks' housing lending activities.

HBOR plays an important role in housing lending in cooperation with commercial banks. Through HBOR's lending programs, banks are given incentives to make housing loans to people without adequate housing. HBOR is a state-owned development bank which is able to issue loan guarantees and debt instruments with the strength of the Croatian government.

It should be noted that residential mortgage lending in Croatia is hindered significantly by ineffective legal mechanisms for foreclosing on collateral. For this reason banks' lending terms are very conservative. Housing lending terms are discussed in part 4 of this report. Ineffective legal mechanisms for realizing collateral include:

- Slow and ineffective court system in general.
- Various problems with the land registry system.

¹ Unless otherwise indicated, the source of data in this report on the banking system is Croatian National Bank.

- Laws favoring consumers over lenders in foreclosure.

Foreclosure practices are discussed more fully in part 5 of this report.

There are no other specialized non-bank mortgage lending companies, and there is yet no secondary market for mortgages in Croatia. Standardized documentation for housing lending, which would promote the development of a secondary market for home mortgages, is not in use. There is no government or private mortgage guarantee insurance.

Potential Housing Lenders in Future.

Municipal or county governments are a potential source of housing development. With only a few minor exceptions, bank lending has to date been virtually the only source of financing for county and city governments. Bond issues by municipalities have occurred only rarely and on a very small scale.

City and county governments are considered good credit risks because their financing is governed by laws based on the German model, which makes it improbable that municipalities can become bankrupt. Plus, the restrictions described below limit their exposure to credit risk, further strengthening them as borrowers.

Municipal and county governments face certain restrictions on their banking activities. First, they are restricted by law to dealing with only one commercial bank during the operating year. And second, their total borrowings are subject to a limitation. Total debt service (principal and interest payments) may not exceed 20 percent of total budget revenues.

‘Housing savings banks’ are a new type of banking institution based upon the German savings bank model. These institutions have the potential to stimulate housing lending, but they have only just begun to lend to their savers.

In the future, the housing savings banks will make up a more significant portion of the housing lending market. Under the Law on Housing Savings Banks (1997), banks and savings banks may establish separate housing savings banks, and these institutions enjoy significant government subsidies. Clients’ contributions to savings accounts of up to HRK 5,000² per year are matched by a 25 percent government contribution. In addition, housing savings banks are not subject to banks’ reserve requirements.

Housing savings banks can make loans for purchasing or repairing houses, both in domestic currency and with foreign currency clause³, and can issue securities with up to 6 year maturity. It should also be noted that counties and municipalities may save and borrow from Housing Savings Banks for the purpose of constructing apartments for people without proper housing. A copy of this law is attached to this report. The names and owners of the four housing savings banks are shown in the following table.

² The exchange rate is 8.37 HRK per 1 U.S. dollar as of July 18, 2001.

³ Foreign currency clauses for savings accounts and housing loans were authorized under an amendment to the Law on Housing Savings Banks in 1999.

List of Housing Savings Banks

Housing Savings Bank	Bank Owner
Hrvatska Stambena Stedionica	Various
Prva Stambena Stedionica	Zagrebacka Banka
Raiffeisen Stambena Stedionica	Raiffeisenbank Zagreb
Wustenrot Stambena Stedionica	HVB Bank Croatia (Bank Austria)

2.2 Investment Bankers

The major investment banks in Croatia are also commercial banks. The most active are Zagrebacka Banka, Privredna Banka, and Raiffeisenbank Zagreb.

2.3 Associations Representing Financial Institutions

There are three associations representing Croatian financial institutions:

- Croatian Chamber of Economy.
- Croatian Bankers Association.
- Croatian Institute for Banking and Insurance.

Croatian banks are required to be members of the Croatian Chamber of Economy (HGK), which represents their interests toward the parliament and other government institutions.

Thirteen banks belong to the Croatian Bankers Association (HUB), a private sector non-profit institution.

The Croatian Institute of Banking and Insurance (HIBO) is a non-profit institution which organizes training for the banking and insurance industry.

2.4 Major Participants in Housing and Consumer Lending in ECRA areas

The municipalities covered in this project are small and many do not have bank branches. Moreover, their real estate markets are illiquid and some of them do not have adequate land registry systems. For these reasons, housing lending in the ECRA areas is problematic.

The major participants in housing and consumer lending in ECRA areas are the largest commercial banks (which have nationwide branch networks), regional banks, and, potentially, housing savings banks.

Banks Which are Active Lenders in ECRA Areas

Large Commercial Banks	Regional Banks
Zagrebacka Privredna	Dalmatinska Jadranska Karlovacka Pozeska Sisacka

Data concerning bank branches is published by county. The number of branches in each ECRA-area county is shown below.

Bank Branches in ECRA Communities
 June 2000

County	Number of Branches and Sub-Branches
Sisak-Moslovina	17
Koprivnica-Krizevci	9
Bjelovar-Bilogora	7
Lika-Senj	2
Pozeska-Slavonia	10
Sibenik-Knin	10
Brodsko-Posavska	8
Karlovacka	2

Many ECRA municipalities have at least one branch of a bank, usually a branch of the regional bank. For example, Sisacka banka has branches in Dvor, Hrvatska Kostajnica, Vojnic, and Gvozd.

Most commercial banks seem to operate only in those communities where they physically have branches. The largest banks, Zagrebacka and Privredna, do not compete in many of the smaller counties and have effectively divided up coverage of these counties. However, they sometimes use “briefcase bankers,” individual bank officers who visit clients personally, to serve areas not covered by branches. Raiffeisen Savings Bank intends to cover all areas of Croatia, even where they do not have branches. They will do this by taking account applications at regional centers and accepting payments through post offices.

Thus, regional banks and housing savings banks, as well as the “Big 2” are very important for ECRA project municipalities.

2.5 Other Institutions with Interest in Municipal Bond or Secondary Mortgage Financing

There is considerable real and potential ‘demand’ from commercial banks, investment banks, insurance companies, and pension funds for housing lending, for several reasons:

- Banks view consumer lending as more profitable than commercial lending. Banks have lower write-offs and thus higher overall lending margins on consumer lending than on commercial lending. Over three-quarters of the banks surveyed in 2000 by the Croatian National Bank stated that households were better repayers of loans than firms.
- The banking system is relatively liquid and needs to make more loans to maintain profitability.
- New investment and pension funds are starved for investments, as the capital markets are relatively under developed. The Law on Pension Funds states that up to 30% of funds' domestic investments may be held in local government securities. Within the next few years, this could amount to several billion HRK
- Croatia's 18 insurance companies also represent a significant source of investable funds.
- Collateralized mortgage obligations ("CMOs") have not yet been used in Croatia but could represent a potential stimulus to the housing lending market. CMOs were created in the U.S. in the 1980s and are now used in many countries as liquid, safe investment instruments. CMOs are essentially securitized mortgage loans, sometimes with the backing or guaranty of a local governmental body. By securitizing home loans, lenders place the loans into a "pool," and shares in the pool (similar to bonds) are then sold to investors.

The largest banks have recently established investment funds, similar to mutual funds, to manage customers' assets. Because of a major pension reform program which is just getting started, private pension funds will in the near future become a significant source of investing in the local capital markets. It appears that the large commercial banks will be the managers of pension funds.

3 Financial Sector Profile

3.1 General Structure of Banking Industry

While the Croatian capital markets in general are under-developed, the banking sector is reasonably well developed for a transition country. Commercial banks in Croatia have total assets of HRK 115 billion, or 72 percent of gross domestic product. Bank failures, mergers, and acquisitions have decreased the number of commercial banks from 60 in 1998 to 43 today. The banking industry continues to consolidate through mergers and takeovers. It is relatively concentrated and becoming more so, with two banks today owning 47 percent, and the top four banks owning 61 percent of total assets. Since the privatization of several rehabilitated banks which took place in 2000, the largest banks are all owned by foreign banks from Italy, Germany, and Austria.

Deposits made by individuals into banks, savings banks, and housing savings banks are insured by the State Agency for Deposit Insurance and Bank Rehabilitation (DAB). The maximum insured amount per account is HRK 100,000.

During the 1990s some banks suffered huge losses on commercial lending, and the resulting bank failures cost the Croatian government approximately 30 percent of GDP. The scale of the Croatian banking crisis during the 1990s was similar to those in Thailand and South Korea in the late 1990s.

3.2 Condition of Banking Industry

Today, the sector is relatively well capitalized and profitable, after having suffered losses and several bank failures in 1998 and 1999. In 2000, the average capital adequacy ratio was over 20 percent (or 8.8 percent tier 1) and the average return on assets ratio was 1.9 percent.

Interest rates have been trending downward for several years, but so far lending spreads are not necessarily declining. Lower interest rates is good for borrowers, but means that banks must continue to improve operating efficiency in order to remain their current level of profitability. Interest rates and spreads on local and foreign currency loans and deposits are shown in the following table.

Croatian Banking System, Interest Rates and Spreads

	2001			1999
	Long Term Loans	Deposits (Average of all Maturities)	Spread (Loan rate minus deposit rate)	Spread (Loan rate minus deposit rate)
In HRK	9.99%	3.60%	6.39%	10.87%
In HRK with foreign currency clause	9.83%	5.64%	4.19%	4.19%
In foreign currency	7.50%	3.26%	4.24%	2.34%

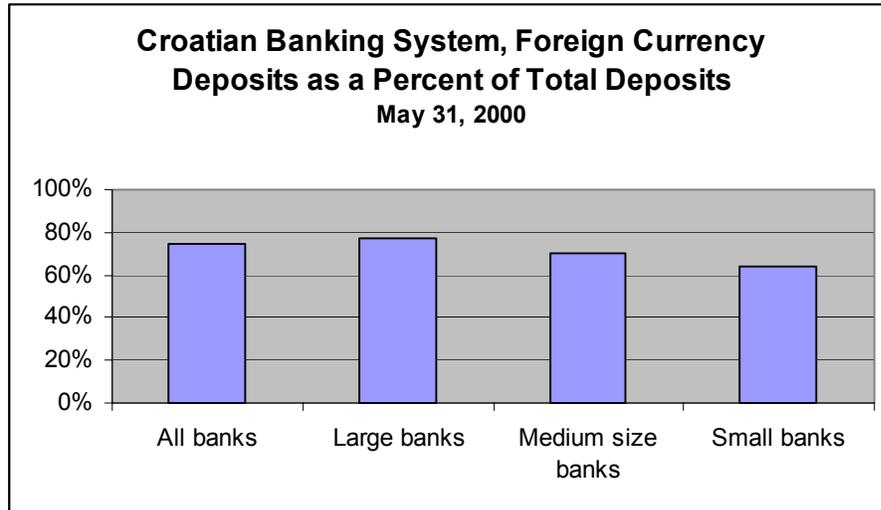
As a result of the consolidation and foreign ownership of the banking system, one can reasonably expect greater competition and the introduction of new products in the near future. These developments may be limited to the larger cities and towns, however, if the volume of business in small communities is not sufficient to support profitable banking offices.

3.3 Bank Lending in Local and Foreign Currency

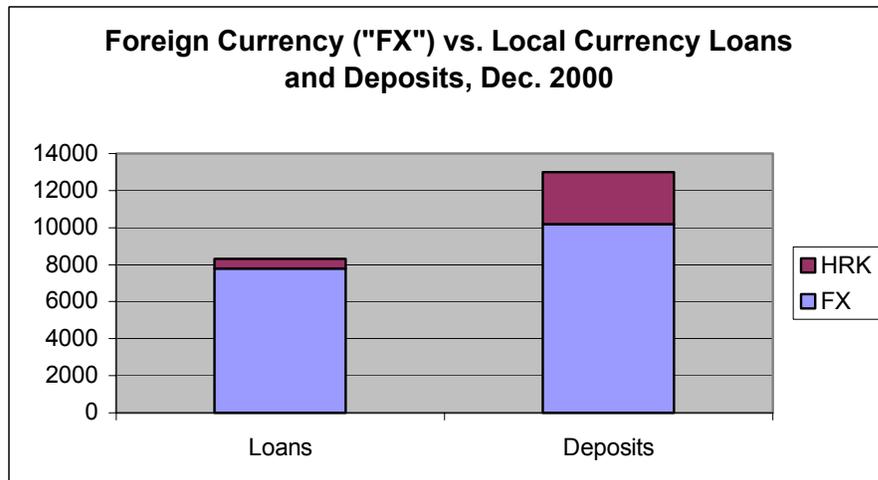
Going back to the 1970s and 1980s, Yugoslavia experienced long periods of high inflation and unstable currency. During this period, citizens were allowed to hold and deposit foreign currency in local banks. Most people saved in foreign currency as a hedge against devaluation of the Yugoslav currency. Croatia also went through a period of hyperinflation just after independence in the early 1990s. While the Kuna

has been quite stable since its introduction in 1994, because of their past experience with inflation and devaluation, people are still reluctant to save in the local currency.

Thus, today over 75 percent of bank deposits are in foreign currency or local currency with foreign currency clause. This level of foreign currency savings is quite high, and illustrates the peoples' lingering lack of confidence in local currency. This phenomenon is shown in the following table.



Banks hedge their own exposure to foreign currency deposits by making most of their loans in foreign currency or in local currency with a foreign currency clause (usually the German mark). One of the largest banks in Croatia has a mix of foreign currency and local currency loans as shown in the following table. This mix of foreign and local currency lending is considered typical for most Croatian banks.



Source: Annual Report 2000, Privredna banka Zagreb, d.d.

Our research indicated that most banks and housing savings banks are making virtually all of their housing loans in foreign currency or in Kuna with a foreign

currency clause. Lenders and borrowers would be better advised to make loans in local currency. The reasons are explained below.

As a result of customers' preference for foreign currency deposits, banks attempt to balance their exposure to foreign currency liabilities by making loans (assets) in foreign currency. This strategy, however, does not completely protect the bank or the customer from the risks associated with a potential devaluation of the local currency.

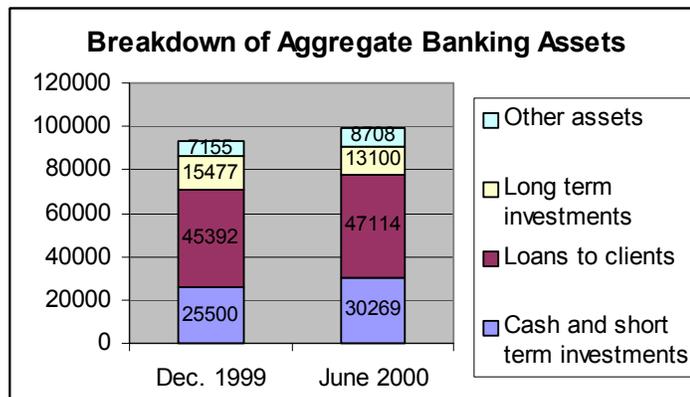
Individuals or businesses that borrow in foreign currency are only protected in the event of a devaluation if their main sources of income are also tied to the same foreign currency.

While most Croatian households borrow in foreign currency (usually the German Mark), local salaries are not linked to foreign currency. A World Bank draft report entitled, "Croatia – Economic Vulnerability and Welfare Study," dated June 2000 noted that the depreciation of the Kuna associated with the banking crisis of 1998-99 "had a negative repercussion on living standards...it was the major factor explaining the fall in personal consumption in 1999 as the interest payments of households for consumer loans have increased dramatically."

3.4 Liquidity of the Banking Industry

The public perception is that the banking sector is quite liquid and becoming more so. This, people believe, is because banks are still reluctant to loan because of their recent experience with loan losses during the local banking crises of the 1990s. However, a thorough analysis of the numbers shows that, while banks do have some capacity to increase their lending activities, on the whole they are not overly liquid.

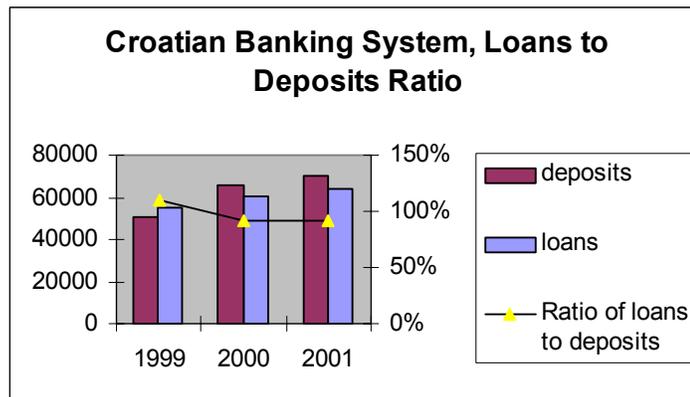
While the situation varies from bank to bank, in the aggregate there is not a large amount of excess liquidity in the banking system. Various measures of liquidity indicate both positive and negative aspects of the banks' liquidity positions. Nonetheless, with the economy having slowed from its high-growth years in 1995-1997, some bankers are reporting that, for the first time in their history, they are now actively seeking borrowers rather than the other way around.



The table above shows that:

- Cash and short term investments (including required reserves) make up about 15 percent of banking assets. This indicates that banks' liquidity is about average as compared to international standards.
- Loans to clients are only about 55 percent of total banking assets. This ratio is low relative to the international norm of about 75 percent, indicating possibly strong liquidity.

By contrast, other figures indicate that the banking sector is less liquid than it should be. Loan to deposit ratios are declining but still quite high compared to an international norm of about 80 percent, as shown in the following chart.



To the extent that the banks are liquid, they should be interested in finding ways to increase their lending activities or buy safe investments such as bonds. Those banks that are not so liquid should be receptive to new means to increase liquidity by moving assets off their balance sheets, such as through securitizations.

3.5 Investment Profiles

There is a shortage of safe, liquid instruments for banks' investment portfolios. Currently, investment portfolios are small and made up entirely of Croatian government debt instruments. There are virtually no municipal or regional bonds on the market. Banks also place their excess liquidity in the local or foreign interbank market or in short term, highly liquid foreign debt instruments.

3.6 Specific Information on Major Potential Housing Lenders

The table below illustrates the comparative sizes, concentration of consumer lending, capitalization, profitability, and geographic reach of the major potential housing lenders in Croatia.

Financial and Branch Data on Major Housing Lenders
Dec. 31, 2000

Bank	Total Assets	Consumer Loans / Assets	Capital Adequacy	ROA (Profitability Ratio)	Branch Network
LARGE BANKS					
Zagrebacka	32,453	19.8%	20.3%	3.0%	Nationwide
Privredna	20,574	18.0%	18.4%	1.8%	Nationwide
Splitska	8,028	16.4%	19.0%	0.6%	Dalmatia
Raiffeisen	5,047	27.1%	19.9%	2.2%	Growing
REGIONAL BANKS					
Dalmatinska	2,559	14.0%	16.8%	na	Regional
Jadranska	1,322	16.2%	21.2%	0.14%	Regional
Karlovacka	787	3.6%	10.0%	0.67%	Regional
Pozeska	401	24.2%	27.0%	5.71%	Regional
Sisacka	525	21.1%	34.0%	0.35%	Regional
HOUSING SAVINGS BANKS					
Aggregate data:	514	0.0%	na	na	Mostly Zagreb to date

Source: Banks – Privredni Vjesnik July 31, 2001; Housing Savings Banks – Croatian National Bank.

3.7 Capital Requirements for Lending Institutions

The minimum amount of capital is HRK 40 million for a full banking license. In addition, Croatian banks, savings banks, and housing savings banks must maintain a minimum capital adequacy ratio of 10 percent. The capital adequacy ratio is calculated in the same manner as the Basel capital adequacy framework for international financial institutions.

3.8 Reserve Requirements for Lending Institutions

Since 2000, the central bank has reduced the rate of required reserves several times. Currently, reserve requirements for banks and savings banks are 22 percent. Up to 60 percent of required reserves can be maintained in qualifying liquid assets, while 40 percent is deposited at the Croatian National Bank. Housing savings banks and the Croatian Bank for Reconstruction and Development are exempt from reserve requirements.

Reserve requirements apply to the following types of liabilities: Kuna and foreign exchange deposits and borrowings; obligations for financial leasing; and non-capital debt securities. The following types of funds are exempt: “frozen” foreign exchange accounts⁴, funds received from another institution that maintains reserves at the Croatian National Bank, relief funds, and funds received from HBOR.

⁴ This refers to individuals’ foreign currency bank deposits which were blocked after the dissolution of Yugoslavia, and subsequently assumed as long term public debt by the Republic of Croatia.

4 Housing Lending Practices

4.1 Loan Origination Criteria

Banks housing lending criteria are quite conservative, for several reasons.

- It is almost impossible to foreclose on real estate collateral due to problems with the courts.
- It would be difficult to sell foreclosed collateral, because real estate markets are not liquid (with the possible exception of the Zagreb area).
- It is difficult to know the value of the property, because there is a lack of qualified real estate appraisers, and banks' in-house appraisal skills are not well developed.

While banks usually obtain and file a real estate mortgage when making housing loans, in effect they rely almost entirely on the customers' creditworthiness as the repayment source for their loans. For this reason, loan terms are stringent.

According to a study by the Croatian National Bank⁵, the main criteria for consumer lending include the income of the individual, the quality of the firm they work in, and documentation that the person is in fact regularly receiving his pay. The use of co-debtors and personal guarantors is very common. These and other lending terms are set by the individual banks, and they vary depending upon the borrower's circumstances.

Potential borrowers must usually submit proof that their property is properly registered in the land registry, even for small loans. The process of documenting land registration is slow at best and impossible in some areas where records were lost or destroyed during the war. Property registration issues can thus delay or even prevent the loan from being made.

From discussions with bankers, the loan origination criteria shown in the table below are considered typical. Lending criteria, of course, vary from bank to bank and may be different for the smaller domestically-owned banks and the foreign-owned major banks. These criteria are discussed more fully in the following paragraphs.

⁵ The Lending Policies of Croatian Banks: Results of the Second CNB Bank Interview Project, 2000.

Typical Origination Terms For Mortgage Loans
Made by Banks and Housing Savings Banks

	Commercial Banks	Housing Savings Banks (in future)
Maturity	7-15 years	7-15 years
Repayment terms	Monthly amortization (direct debit)	Monthly amortization
Ratio of real estate value to loan amount	130-150%	150-200%
Interest rate	8-10% fixed	6% fixed
Penalty interest rate (when payments are late)	18% or higher	18%
Loan fees	0.5 to 2% plus 1% notary (filing) fee	0.5% to 1% plus 1% notary (filing) fee
Cash deposit as percent of loan	20-30%	50%
Interest rate on cash deposit	2-3%	3%
Currency	HRK with DM clause	HRK with DM clause
Ratio of loan payment to monthly income	33%	33%
Number of personal guarantees	0 to 3	0 to 3

Maturity. Loans are made for longer terms when other factors are favorable, such as the value of the collateral and the number of guarantors.

Repayment terms. In commercial banks, loans are almost always repaid monthly by means of debiting the customer's account. Salaries must be deposited directly to the bank.

Ratio of real estate value to loan amount. The value of the property must be significantly higher than the loan amount. The ratio can be lower if the borrower has other positive factors, such as a large deposit in the bank or a higher number of co-debtors or guarantors.

Interest rate. Banks' lending rates have been falling over the last few years as interest rates in general have declined. They usually lend at a fixed interest rate, but sometimes use variable rates. When the rate is variable, it usually varies at the bank's option or follows movements in Euribor⁶. Caps and floors are not used. There is no widely used local interest rate index⁷. Since rates have generally fallen in recent years, there is no history of borrowers with variable rate mortgages being adversely affected by rises in interest rates. Because of their state subsidies, housing savings banks may be able to make loans for lower rates. Their typical spread between

⁶ Euribor refers to an index made up of the average interbank rate in Euroland.

⁷ "Zagrebor" is a local index of the interbank rates of the four largest banks. However, bankers believe the universe of banks is too small and the local interbank market too volatile for this to be a reliable index.

savings and lending rates is expected to be about 3%, which is lower than banks, but this is up to the individual institution to determine.

Penalty interest rate. Late payments are assessed a ‘penalty interest rate’ from the first day the loan is past due. Usually, when the loan is 30 days delinquent, the penalty interest rate is applied to the entire loan amount.

Loan fees. These vary from institution to institution but can be a significant cost of borrowing. The Croatian National Bank has recently issued a regulation requiring banks to calculate the total costs (interest and fees) of loans based upon a standard methodology. The result should be that consumers can more easily compare the costs of borrowing from different institutions.

Cash deposit. When banks lend, they often require the borrower to deposit a certain sum of money and maintain it in the bank during the loan term. The amount required depends largely upon other credit factors, such as the value of the collateral and the interest rate of the loan. Housing savings banks have a different procedure: borrowers regularly increase their savings by a certain amount for a fixed period; when a loan is made, the savings account is closed and returned to the borrower; the loan amount varies but is typically about two to four times the amount of the deposit.

Interest rate on cash deposit. For commercial banks, the interest rate paid on any cash deposit will vary depending on other credit factors. The manager of one housing savings bank stated that housing savings banks will typically pay 3% and maintain a 3% spread (i.e., loan rates will be about 6%).

Currency. The large majority of bank and housing savings bank loans are or will be in foreign currency. However, there is no legal restriction against lending in local currency. Those loans which are made in local currency usually have a slightly higher interest rate than those made in foreign currency or with a currency clause.

Ratio of loan payment to monthly income. This factor is set by the individual institution.

Number of personal guarantees. The number of co-debtors or guarantors depends upon other credit factors, but it is higher when the borrower’s income is low or the value of the collateral is low.

Property transfer taxes add 5 percent to the cost of real estate purchased.

4.2 Loan Origination Procedures

The origination process can be lengthy, mainly because of the time needed to resolve land registry issues. The Croatian National Bank found in a survey of banks that the time between application and loan approval (for all types of loans) is about 1-2 weeks for smaller banks, and over two weeks for larger banks. This applies only to the bank’s lending process and does not include delays associated with the borrowers resolving land registry or other personal issues.

Most banks have a risk management process whereby applications are screened before being submitted to a loan committee for approval. Guarantors are obliged to come to the bank or to the public notary to sign guarantee documents. Banks handle their own loan closings. Lenders often do not record the mortgage on small loans (i.e., under about DM 20,000) because filing fees are high and the likelihood of collection by sale of collateral is low.

Fiduciary ownership of property, rather than mortgages, is theoretically possible. However, this type of lending is relatively new and untested. Many banks believe this type of lending, where the bank or a trustee would take ownership of the property until the credit was repaid, as preferable to traditional mortgage lending. The advantage is that fiduciary ownership can be activated quickly without a court judgment.

4.3 Differences by Type of Housing Unit and Size of Community

The origination criteria and procedures described above apply mainly in the Zagreb area. Fewer housing loans are made outside Zagreb, but presumably the terms would be more conservative. There are no significant differences based upon the type of housing unit (i.e., house vs. apartment).

5 Loan Default and Foreclosure Practices

5.1 Historical Data on Foreclosures

Consumer lending has only become commonplace in the last few years, and foreclosures are still a rare occurrence. In a recent survey, the Croatian National Bank found that an astounding 30 percent of banks had never succeeded in foreclosing property. About half the banks stated that the average foreclosure time is more than two years, and 40 percent stated that the time is 6 months to 2 years. The banks stated that land registrations and foreclosures are slowest in Zagreb.

5.2 Loan Default and Foreclosure Practices

According to a study by the Croatian National bank, the default rate of households is substantially lower than the default rate of firms. This may be a result of the practice of requiring co-debtors or guarantors, whereby banks can put moral pressure on households that do not repay promptly. Banks' stringent lending criteria and quick collection action means that the default rate is low and there is rarely a need to initiate foreclosure proceedings.

While collection procedures vary from bank to bank, typically banks react automatically when a payment is late. The "penalty interest rate" begins accruing on the missed payment amount on the first day it is past due. After 30 days, the penalty rate begins to apply to the entire loan.

After a certain time, usually within 30 days, banks send a collection letter to the borrower and any co-debtors or guarantors. The next step is to initiate court action

against the borrower and the co-debtors or guarantors. By this point most problems are resolved. Only after these steps have been taken do banks use the foreclosure process.

Courts are slow to reach judgments on foreclosure and to enforce those judgments. This is one of the main problems facing banks as creditors today. Bankers do not believe the situation is improving.

ATTACHMENT 1

“Banking and Finance”
Croatian Chamber of Economy

ATTACHMENT 2

Law on Housing Savings Banks

ATTACHMENT 3

“Standard Presentation Format”
Croatian National Bank

ATTACHMENT 4

“Banking Bulletin”
Croatian National Bank

ATTACHMENT 5

“The Lending Policies of Croatian Banks: Results of the Second CNB Interview Project”
Croatian National Bank

ATTACHMENT 6

“Municipal Bonds Seminar”
Varazdin Securities Market, November 26, 1999

ATTACHMENT 7

LIST OF RELEVANT WEB SITES

Zagreb Real Estate Market: *burzanekretnina.com*

Croatian Bank for Reconstruction and Development: *hbor.hr*

Croatian Bankers Association: *hub.hr*

Croatian Chamber of Economy: *hgk.hr*

Croatian National Bank: *hnb.hr*