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FINANCIAL REGULATION AND SUPERVISION IN CROATIA*

Key words: financial system, financial institutions, regulation, supervision, coordination, Croatia

ABSTRACT

There is a trend towards integration of financial regulation and supervision in Europe and in developed overseas countries. Nevertheless, integrated regulatory bodies are quite unusual worldwide and this relatively new structure should be examined in detail. There are a number of different models of the institutional structure of financial regulation and supervision specific to every country, and the question is what will be the best solution for Croatia?

The problems of authority overlapping and insufficient regulation are becoming more complex by the development of Croatian financial sector. Although banks dominate the Croatian financial market, that has been threatened by the rapid growth of non-deposit financial institutions, especially investment funds and compulsory private pension funds. Also, there is a problem of formal or informal financial groups that are gathered around few banks owned by foreigners. Accordingly, one can say that Croatian financial market is dominated by financial conglomerates. That complexity enables them to avoid rules and regulations of financial supervisory authorities. Because of the growing role of financial groups it is necessary to coordinate work of different supervisory authorities and consider unification of different regulatory bodies.

Only two years ago, supervision of Croatian financial system consisted of six independent regulatory institutions entrusted with different financial services ("solo" supervision), without any sufficient coordination of their activities. By adopting new laws in 2005, their partial integration started, based on two separate agencies. Croatian supervisory model at the moment is consisted of two regulators of the financial system, i.e. Croatian National Bank (HNB) and Croatian Financial Services Supervisory Agency (HANFA). This is an

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example of the twin peaks system, when banking supervision is carried out by the central bank (HNB), while non-bank financial institutions are regulated and supervised by another supervisory authority (HANFA).

The aim of this paper is to discuss the present institutional structure and effectiveness of financial regulation and supervision in Croatia and to point out possible future development of the Croatian supervisory model.

1. INTRODUCTION

A stable and efficient financial system is vital for economic growth, especially in developing countries. One of the major prerequisite for developing and strengthening a financial system is achieving an adequate financial regulation and supervision system.

In recent years, revolutionary changes in financial systems have appeared. These forces of change include the process of liberalization, globalization, deregulation, technological changes and introduction of financial innovation. Therefore, the task of strengthening financial system regulation and supervision in order to promote more efficient and robust financial system, gain importance for any national economy. One of the most common and important characteristics of modern financial systems is the increasing role of financial conglomerates as group of different financial institutions under common ownership. They can cause numerous problems for supervision agencies because of lack of transparency, higher operational risks and others.

Because of these comprehensive changes and developments of financial system worldwide, extending the traditional approach of financial regulation based on prudential supervision and capital requirements may be too costly and difficult. Therefore, it is necessary to identify some alternative regulatory approaches which will promote greater financial security and stability, particularly concerning supervisory structure of financial systems.

2. RELEVANCE OF FINANCIAL REGULATION AND SUPERVISION STRUCTURE

Regulation of financial system entails setting rules and establishing an enforcement mechanism designed to control the operation of the system's constituent institutions, instruments and markets. The main objective of financial regulatory policy is to maintain the health of financial system and minimizing the risk of financial crises. Hence, financial market disruptions should not have a significant impact on aggregate real economic activity.

Two main types of financial regulation and supervision can be identified:

- Prudential supervision
- Product regulation (consumer protection)

Prudential supervision has the primary objective of promoting the stability and financial soundness of financial institutions and financial system. The focus is on protecting the institutions solvency. It involves different techniques of risk management - capital adequacy standards, liquidity ratios, asset restrictions, systems for managing various risks, limits on large credit exposures, reliance on professional experts such as external auditors and actuaries, regular reporting and disclosure, strong surveillance and enforcement powers for the regulators and so on. The second category of financial regulation (i.e. consumer protection) refers to fair treatment of investors and borrowers. Also, it promotes competition and efficiency by improving the quality of market information for market participants. Consumer protection regulation uses disclosure and conduct rules as its major tools. Concerning these different tasks and conflicting objectives of stability and consumer protection, the regulation of financial systems continues to evolve over time.

In general, the main infrastructural models of supervisory systems are:

- The sectoral model – each sector of financial system is supervised by one independent supervisory agency.
- The "twin-peaks" model – responsibilities are allocated on the basis of the supervisory objectives, with prudential supervision and investor protection attributed to two distinct agencies.
- Model of single supervisory authority – prudential supervision and conduct of business regulation are issues of one supervisory agency. The national central bank can be separate form this supervisory authority or all the supervisory functions can be transferred to the national central bank. This is a proper solution for relatively small and undeveloped financial markets, particularly transition countries.

Although, national choices for the organization of structure of financial supervision differ and may be the consequence of history and the specific elements and relations concerning the national financial system, some general common tendencies can be drawn, particularly for the transition countries. There is a trend towards consolidation of supervisory authorities, a close involvement of central banks in prudential supervision and increased tendency to formalize cooperation among supervisory authorities and between other authorities, thus contributing financial stability.[1]

There are two main operative reasons for transition countries to adopt single supervisor model. The first is the desire to achieve economies of scale in regulation. The second main

[1] See *Recent Development in Supervisory Structures in EU and Acceding Countries* (2006), European Central bank (October).

reason is the desire to respond to the formation of financial conglomerates, as a perceived need to bring greater clarity and consistency to the regulation of complex financial groups.[2]

There are a number of very unique problems that come into play when a transition economy decides to move to an integrated model of supervision from a fragmented one. In most instances in CEE countries there has been a significant effort to strengthen the supervisory framework for banks, because, in general, these economies are dominated by banks. While the strength of these agencies varies from country to country, they are perceived to be the strongest of the financial supervisory agencies. The institutional impediments to effective prudential regulation in developing countries include weak accounting standards, the poor quality of information available to regulators and the market, acute shortages of the professional skills needed for regulation, the politicization of regulatory processes and the difficulty in enforcing bureaucratic and legal regulations.[3]

The growing concern in many transition economies is to ensure that the financial sector as a whole is subject to supervision so that regulatory "gaps" do not appear. However there is a fear that if banking supervision is removed from the Central Bank to combine with weaker supervisory bodies for other elements in the financial system then this will lead to some adverse effects.

Structure of national supervisory systems of EU Member States describes Table 1.

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[2] For the arguments on separation and for unification of financial system supervision, see Goodhart, C. et. al. (1998), *Financial Regulation: Why, how and where now?*, Routledge, London.
[3] Brownbridge, M. and Kirkpatrick, C. (2002), *Financial regulation and Supervision in Developing Countries: An overview of the Issues*, Development Policy Review, Vol. 20, 243-245.

Table 1 Supervisory structures in the EU Member States and acceding countries

EU Member States	Sectoral model	Model by objectives	Single supervisor model	Number of authorities responsible for supervision	The national central bank has supervisory tasks or responsibilities
BE	X	→	X	1	
CZ	X	→	X	1	X
DK			X	1	
DE	X	→	X	1	X
EE	X	→	X	1	
GR	X			3	X
ES	X			3	X
FR	X	X		4	
IE	X	→	X	1	
IT	X	X		4	X
CY	X			4	X
LV	X	→	X	1	
LT	X			3	X
LU	X			2	
HU	X	→	X	1	
MT	X	→	X	1	
NL	X →	X		2	X
AT	X	→	X	1	X
PL	X	→	X	1	
PT	X	X		3	X
SI	X			3	X
SK	X	→	X	1	X
FI	X			2	
SE			X	1	
UK	X	→	X	1	
Total	**10**	**4**	**14**		**12**

* → The arrow indicates changes in supervisory structure model

Source: *Recent Development in Supervisory Structures in EU and Acceding Countries* (2006), European Central bank, (October), p. 5

It can be seen that there is a trend towards reducing the number of supervisory authorities. Single supervisory model has been accepted by most of the countries. Although, sectoral model is still relatively widespread, in the last few years, thirteen countries have moved away from this model.

3. FINANCIAL SYSTEM IN THE REPUBLIC OF CROATIA

Croatian financial system in general is underdeveloped as compared with financial systems in developed market economies. Croatian financial system consists of almost all types of institutions which usually form an integral part of a developed market. The Croatian financial system is bank-based, private and foreign-owned, highly concentrated and profitable. Banks are predominantly deposit financed and their funds are mainly denominated in or indexed to foreign currencies, mostly the euro. Non-bank financial intermediation is underdeveloped but fast growing. Croatian capital market can be defined as narrow and shallow, despite strong growth of volume and market capitalisation during the past few years.

Table 2 Relative Importance of Financial Intermediaries, shares in total financial intermediaries' assets (end of period, in %)

Financial institution	2000	2001	2002	2003	2004	2005
Banks	87.0	87.5	85.0	83.3	81.4	78.7
Open-end investment funds	0.2	0.9	1.4	1.4	1.8	2.8
Closed-end investment funds	3.0	2.3	1.6	0.4	0.4	1.2
Insurance companies	6.8	5.9	5.7	5.4	5.2	5.1
Housing savings banks	0.4	0.8	1.1	1.5	1.8	1.8
Mandatory pension funds	0.0	0.0	1.1	2.0	2.9	3.6
Voluntary pension funds	0.0	0.0	0.0	0.0	0.0	0.1
Savings and loan associations	0.9	0.6	0.6	0.6	0.5	0.5
Leasing companies	1.7	2.0	3.6	5.4	6.0	6.2
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: www.hnb.hr (*Macroprudential Analysis*, Croatian National Bank, Zagreb, Number 3, 2006., p. 25)

In 2005, the banks possess most of the assets and have the greatest share of assets in the GDP. Banks face grater competition from other financial intermediaries, especially due to a rapid growth of mandatory pension funds and open-end investment funds. Hence, long-standing domination of the banks has been slightly threatened and it is expected that in the next period savings will be to a lesser extent channelled through the banks.

The data in Table 3 represents the proportion of financial institutions assets in GDP for Croatia and other figures concerning the degree of financial intermediation (total assets to GDP) and the degree of economic development (GDP per capita).

Table 3 Financial Market Structure (in 2005)

Financial institution	Assets (in millions of HRK)	% of total assets	Number of institutions	Assets as % of GDP
Banks	260.6	78.7	34	113.8
Open-end investment funds	7.1	2.8	49	3.1
Closed-end investment funds	2.0	1.2	5	0.9
Insurance companies	16.6	5.1	25	6.7
Housing savings banks	5.8	1.8	3	2.5
Mandatory pension funds	12.0	3.6	4	5.2
Voluntary pension funds	0.3	0.1	14	0.1
Savings and loan associations	1.7	0.5	116	0.7
Leasing companies	20.2	6.2	17	8.8
Total	**326.6**	**100.0**	**267**	**141.8**
GDP	229,031 mil. HRK; 30.950 mill EUR			

Source: www.hnb.hr, www.hanfa.hr

As it can be seen from Table 2, more than three quarters of financial intermediation in Croatia is performed by bank institutions. Although in 2005 bank possess most of the assets and have the greatest share of assets in the GDP, the relevance of other financial intermediaries is rapidly expanding. Banking sector appear to lose their relative importance in comparison to non-bank financial intermediaries. Besides leasing companies[4], the most propulsive financial intermediaries are open-end investment funds and mandatory pension funds. Banks are almost three times smaller in number than savings and loans associations, and there are roughly as many banks as insurance companies and investment funds.

The structure of financial markets can be seen from Table 4, presenting the relative relevance of different types of financial instruments.

[4] Leasing companies took the second place with a share of 6.2%. However, this significant share and rapid growth is the result of Croatian National Bank monetary restrictions considering regulation of credit activity and acquiring the necessary liquidity of banks. Majority of these institutions have tight connections with banks, because banks are establishers of leasing companies with main goal of giving up part of their credit activities to less regulated and supervised leasing institutions.

Table 4 Financing in the Republic of Croatia (in millions of HRK)

Financing in the Republic of Croatia	Amount	% of total amount	% of GDP
Bank loans	151.9	56.9	66.2
Market capitalisation – shares	80.7	30.2	35.2
Market capitalisation – bonds	34.4	12.9	15.0
Total	**267.0**	**100.0**	**116.4**

Source: www.hnb.hr, www.hanfa.hr

From data in Table 3 it can be seen that for the purpose of external financing, Croatian economy prefer credit financing. Issues of various types of securitites is rarely used, partly due to a long tradition of banking market and unacquitance with possibilities of the capital market by market participants. The bank loans are prevalent, however not to the extent in which the banks' assets dominate the total assets of the financial system. The reason for that is that banks in their portfolios also have large portfolios of shares and bonds.

Croatian capital market is still underdeveloped and it cannot be compared to that of the developed market economies. The primary market confirms the still negligible role of the capital market in financing the Croatian economy. In 2005 there was only one share issued by public offering and only two such issues of corporate bonds. The secondary market is much more developed, but some securities market segments such as derivative markets do not exist. Croatia's capital market in 2005 is marked by rapid growth in almost all aspects of trading figures, to the greatest extent as a result of the rise in liquidity of institutional investors, particularly pension funds.

4. FINANCIAL REGULATION AND SUPERVISION IN THE REPUBLIC OF CROATIA

Financial regulation and supervision of the Croatian financial system, in the forms corresponding to the international standards, began to be built in the Republic of Croatia in 1990's. This gradual process started in the banking sector with establishment of Croatian National Bank and continued in other parts of the financial system with several different regulatory agencies. The consolidation of national supervisory system started officially started in 2006, by reducing the number of supervisory authorities and establishing the "twin peaks" model. Croatian National Bank is a supervisory authority responsible for prudential supervision of bank institutions. The functions of investor's protection and regulation of non-bank financial institutions are concentrated in new institution – the Croatian Financial Services Supervisory Agency (HANFA).

4.1. Regulation of banking financial institutions

Banking financial sector in Croatia comprises two types of financial institutions: banks (and foreign bank branches) and savings banks. These institutions in Croatia are under supervision authority of Croatian National Bank, as provided by the Croatian National Bank Act (Official Gazette 36/2001) and the Banking Act (Official Gazette 84/2002). Its role and importance is especially pointed out by the fact that the banks dominate the financial system in Croatia, and that the bank loans are the most important financial instruments.

Central bank in Croatia is an independent financial institution with autonomy in bank supervision area. Besides the supervision of individual banks, the Croatian National Bank conduct the supervision of banking groups on the basis of consolidated financial statements and supervisory reports, which may result in prevention or restriction of competition in providing of banking services. Banking supervision includes reviews whether the banks operations are in accordance with the laws and regulations, including also the assessment how a bank manages the risks to which it is exposed in its operations, for reducing the possibility of the bank's bankruptcy. The objectives of such an approach are to protect the bank's clients and deponents and to take care of stability and safety of the entire banking system.[5]

The Prudential Regulation and Bank Supervision Area of the Croatian National Bank is responsible for adopting new and aligning the existing prudential regulations with international standards in bank supervision, analysing financial reports and records of banks, on-site supervision of banks, bank branches and representative offices of foreign banks in the Republic of Croatia, analysing data and indicators and for preparing standard reports on the Croatian banking system. The Prudential Regulation and Bank Supervision Area is also responsible for processing applications of banks for various authorisations and for the protection of market competition.

Bank supervision conducted by the Croatian National Bank comprises the following areas of activity and responsibilities:[6]

- entry of banks into and exit from the market and bank business operations (granting operating licenses, supervisory measures, reporting, special administration, liquidation and bankruptcy of banks);
- determining the accountability of the bank's owner for the bank's operations (internal organization of a bank, audit);
- determining the methods for the bank's risk management (determining the capital and capital adequacy of a bank, risk management);

[5] Prohaska, Z. and Olgić Draženović, B. (2004), *Consolidated Supervision of Financial institutions and Financial Market in the Republic of Croatia,* Proceedings of Rijeka Faculty of Economics, Vol. 22 (2), 29
[6] http://www.hnb.hr/supervizija/esupervizija.htm?tsfsg=5b1f10150ed692cd1c961012fb1cbda7

- consolidated supervision of banks (determining the scope and frequency of consolidation, as well as the content of consolidated financial statements);
- consumer protection (determining a uniform method for calculating and disclosing loan and deposit prices and other elements of the loan contract and cash deposit contract);
- protection of the Croatian National Bank employees involved in bank supervision (liability for damage);
- cooperation with other supervisory bodies in the country and abroad (data processing and communication of information).

4.2. Regulation of non-banking financial system

Non-banking financial institutions in Croatia include investment funds (open-end and closed-end), leasing companies, pension funds (obligatory and mandatory) and insurance companies. All these institutions come under supervisory authority of the Croatian Financial Services Supervisory Agency (HANFA), including auxiliary financial institutions such as brokerage companies, investment consulting companies, regulated stock markets, insurance underwriters, etc. HANFA was established in 2006, within the enforcement of the Act on Croatian Financial Services Supervisory Agency (Official Gazette, No 140/05). The fundamental objectives of the Agency are promotion and maintenance of stability of the financial system and supervision of legality of the entities operations.

Prior the establishment of HANFA, several different agencies where conducting supervision and regulation of the mentioned non-bank financial intermediaries and other subjects of the Croatian financial system. These institutions were:

1. The Securities Commission of the Republic of Croatia
2. Agency for Supervision of Pension Funds and Insurances
3. Directorate for Supervision of Insurance Companies

Supervisory authorities of The Securities Commission of the Republic of Croatia were the operations of stock exchanges, regulated public markets, authorized companies (brokerage companies and banks licensed to trade in securities), issuers of securities, investment funds, brokers, investment advisers, institutional investors and the Central Depository Agency.

The Agency for Supervision of Pension Funds and Insurances (HAGENA) was established in 2001 for the purpose of implementation of pension reform in the Republic of Croatia. In general, primarily goal of Agency is to organise, encourage and improve the development of Croatian pension market. HAGENA has supervised the following financial institutions:

- companies managing compulsory pension funds and compulsory pension funds,
- company managing optional pension funds and optional pension funds,
- banks holding pension funds in trust,
- pension insurance companies,
- Central Registry of Insured Persons (REGOS).

In its operations, HAGENA supervised assets and liabilities of all pension funds on daily basis, as well as interim financial statements of pension fund management companies and pension funds. Regular direct supervision of the operations of compulsory pension fund management companies and compulsory pension funds managed by them is done on a yearly basis.

Directorate for Supervision of Insurance Companies supervised the insurance and re-insurance companies. In performance of the tasks and duties of the Directorate, a part of them was related to processing of the document required for issuance of authorizations to insurance companies and a part to supervision of companies operations.

In order to avoid unnecessary costs and inefficiencies, these different agencies were integrated in one, unified institution. HANFA become a regulator that combines the previous agencies with responsibilities for component entities. Also, HANFA supervises the leasing companies in Croatia with goal to prevent these companies from extending new non-leasing credits. Before establishing HANFA in 2006, leasing companies weren't regulated and supervised by any institution.

Besides HANFA and CNB, there are some other institutions that have certain impact on the Croatian regulatory system. The State Agency for Deposit Insurance and Bank Rehabilitation (DAB) is responsible for administering the deposit insurance system and for implementation of bank rehabilitation procedures.[7] The Department for Financial System of the Ministry of Finance of the Republic of Croatia is responsible for drafting, in cooperation with other institutions, legislative proposals in the area of financial services. There are also institutions such as the Croatian Registry of Credit Obligations (HROK), the Central Registry of Insured Persons (Regos) and the Financial Agency, which provide specific auxiliary services to other participants in the domestic financial market.

4.3. Perspectives

In light of the present architecture of Croatian financial system and its future development and changes, it is important to reexamine the existing regulatory framework and to propose the appropriate regulating strategy. It is important that decision on chosen organizational structure of supervisory system take into account country-specific characteristics such as institutional set up and the degree of financial market integration.

Most of the authors agree that in the relatively small and underdeveloped financial system the supervisory responsibilities should be unified in a single regulator. This tendency for integrated supervision tends to reflect the underlying integration of financial markets. The main driving forces behind this tendency are the changing, more blurred structure of the

[7] Under a 1998 decision by the Ministry of Finance, savings deposits of households were insured up to 100,000 HRK per depositor per bank or saving bank.

financial system, and continuing concerns with conflicts of interest.[8] One aspect in this context is the growing importance of financial conglomerates and another aspect is that channels of distribution of financial products are no longer as specialised as they used to be. Banks use their branch network to sell, e.g., insurance products or even non-financial products. Moreover, one can observe a blurring of boundaries between financial products. These financial market developments are often labelled with the notions *bancassurance* and *Allfinanz*.[9]

In Croatia, however, the capital market and non-bank intermediaries are in the beginning of their development but there can be noticed very high growth rates and robust development. Also, it is evident that process of blurring of the traditional distinction between banks and investment sectors and increasing financial market integration has started. The ongoing consolidation trend in the Croatian financial system and the establishment of new types of financial institutions have led to the creation of financial conglomerates or groups of financial institutions that are, in the case of Croatia, gathered around several biggest banks in foreign ownership.

Under a single roof, heterogeneous financial groups unite a broad range of banking, investment and insurance operations, each subject to quite different types of risks. In this context, the accelerated establishment of heterogeneous financial groups in recent years has increasingly focused the supervisory authorities' attention on improving and better coordinating the supervisory regime.[10]

One of the possible answers to supervision problems posed by conglomerates is a lead regulator model. In this, each supervisor retains its individual responsibilities but one agency also oversees the health of the conglomerate as a whole and coordinates remedial action if a serious problem threatens.[11]

A step forward was made by forming standing Working Committee for Financial System Supervision, whose primary objective is supervision enhancement and efficiency improvement. The Committee comprises six members, three from each supervisory agency (CNB and HANFA) and three from Ministry of Finance. Also there have been made some notable improvement considering cooperation between two Croatian supervisory institutions. In 2006, CNB and HANFA concluded an Agreement on Cooperation, which express their readiness to cooperate with primary goal of promotion and safeguarding of financial system stability. Even better results would be made by institutional formalization

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[8] Goodhart, C. et. al. (1998), *Financial Regulation: Why, how and where now?*, Routledge, London.
[9] Schüller, M. (2004), *Integrated Financial Supervision in Germany*, Discussion Paper No. 04-35, ZEW, Centre for European Economic Research
http://ftp.zew.de/pub/zew-docs/dp/dp0435.pdf
[10] Stöffler, G. (2004), *Supervision of Financial Conglomerates*, Financial Stability Report, 8, p. 107
[11] *Prudential Supervision and the Changing Financial system* (1996), Reserve bank of Australia Bulletin (April) (http://www.rba.gov.au/PublicationsAnd research/Bulletin/bu_apr96/bu_0496_3.pdf)

of the mentioned cooperation activities i.e. by the creation of the institution that will improve and formalize communication and understanding among the two present regulators, especially concerning the activities of the financial conglomerates. This should lead to more formal arrangements to promote coordination and sharing the information in Croatian supervision system. For this integrated approach there is a need for advancement of legal framework and conducting a law concerning the regulation of financial groups.

5. CONCLUSION

Financial institutions, as a part of financial system, are vital for the national economy but also they are a source of risk and can be affected by risks from the rest of the economy. A necessary condition for building confidence in the financial sector is a strong, independent and decisive supervision of financial system. Therefore, the regulatory framework needs to be adequate and tailored by the country's level of economic development.

Changes in Croatian supervisory system were intensive with implementation of the new Act on Croatian Financial Services Supervisory Agency. The institutional structure of Croatian financial supervisory system consists of two separate agencies responsible for banking and non-banking financial system. It is expected that these institutional framework changes will enhance responsibilities of each supervision authority and improve efficiency in conducting their supervisory activities.

Interdependency among various financial sector segments and creation of financial groups in the Croatian financial system calls for organizational integration under one roof of regulatory institutions in order to make regulation more consistent and effective. Nevertheless, consolidated supervision of the banking sector and unified supervision of all non-banking financial institutions along with the improved cooperation between regulatory agencies, should be sufficient for banking supervision and consumer protection in the forthcoming years. Finally, when the financial market would be much more sophisticated and more developed in non-bank financial sector, it would be possible and reasonable to introduce a single supervising institution for the entire Croatian financial system.

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