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see country reports on [www.agripolicy.net](http://www.agripolicy.net) for full list of authors

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# 1 Introduction and background

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## 1.1 An outline of rural credit facilities

A functioning rural finance system is essential to the development of rural areas as it provides the necessary finance to farms and SMEs. However, the application of the OECD definition of rural areas to Croatia shows that Croatia exhibits a high degree of rurality. Because of these results, our analysis is based on two aspects: agricultural credits and credits to SME's in general.

The financial sector in Croatia constantly grows and develops in quality and quantity terms. Today, it is a highly competitive and innovative market that has already reached EU standards. Commercial banks (mainly in foreign ownership) are the major players in the financial sector. Credit policies are mainly oriented to households and the share of household loans in total bank financing is 49.6%. Networks of the banks' branches bring financial products to almost every corner of Croatia.

During 2005 there were 1047 bank branch offices in Croatia. Considering the number of branches and the number of Croatian inhabitants, there are 4.243 inhabitants for every one bank branch office in Croatia. During the first six months of 2005, the number of ATMs increased by 6.8% so, at the end of this period, there were 2.043 ATM machines. Despite the fact that the financial market is highly competitive, credits to agriculture are still scarce. Banks lack experience in dealing with small farmers. Loan collateral and high transaction costs, low profitability of farms, and high risk, represent the main constraints. Apart from commercial banks, there are savings and credit cooperatives, but they are small and have a relatively low importance in rural finance.

In order to improve the supply of agricultural loans, the national government (alone or with local authorities) intervened heavily in the past. The SADA<sup>1</sup> Account of the Ministry of Agriculture and Forestry was a classical example of an inefficient subsidized and directed credit program. Scarce budget sources were granted to family farms on the basis of social rather than economic criteria. Approval criteria were not transparent and no monitoring was carried out. As a result, debts rescheduling, restructuring and sometimes writing-off have been undertaken.

Nevertheless, recently, in the process of agricultural policy reform, the model of capital investments, (one of the reform's pillars), has been established (in 2002). It is aimed at encouraging the development of business relations between commercial banks and farmers. The model can be described as the assigning of irretrievable capital from the budget of the Republic of Croatia.. Apart from agriculture, SME's (including those operating in rural areas) have taken the advantages of financial support and privileged credit conditions.

Other aspects of the rural financial system, like insurance, leasing of agricultural machinery and trade finance, are scarce. The demand side of rural finance markets is also burdened with problems. The rural population is mainly engaged in agricultural activities. Farms are small and fragmented and non-specialized. The Farmers' population has unfavorable demographic and educational features. Farmers have insufficient information and lack a focus on training in

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<sup>1</sup> Special credit account for development and reconstruction of agriculture

rural finance, and at the same time the supply of consultancy services in rural finance is lacking.

## **1.2 Major credit and rural policy developments in 2005**

Recent developments in Croatian relations with the EU enable Croatia to use the pre-accession programs for structural and rural development (e.g. Phare, ISPA, SAPARD). The most important activities in Croatia were connected to the SAPARD program. These new circumstances give rather high chances to invest in agriculture and the rural economy, helping structural problems to be solved and competitiveness to be improved in production that lags behind European averages. The selection of the projects should start soon, after the SAPARD agency in Croatia is accredited. The interest of the farmers and entrepreneurs is great. Commercial banks also have interest in such a project because the selection process will help diminish the risks.

In order to improve farms' competitiveness in the process of EU accession in the year 2004, policy makers have initiated incentive programs for investments in agriculture (so called Operational plans). To date, two programs have been launched, one for establishing perennial crops and another for cattle production<sup>2</sup>. Programs for pig and vegetable production are prepared. Programs are financed through the state owned bank, the Croatian Bank for Reconstruction and Development (HBOR). The Croatian agency for SME's is also involved as a guarantee provider. These programs are also subjects of governmental subsidies through the Capital Investments Model. This model of capital investments for commercial agricultural holdings was established in 2003. It included the assigning of irretrievable capital from the the budget of the Republic of Croatia. Through this measure the Ministry of Agriculture, Fishery, Forestry and Water Management takes part in financing investments for which financial institutions approved credit.

Constant scientific research, training and/or consultancy services for farmers, rural enterprises or banks in Croatia unfortunately do not exist, although the interest and needs for such services are pressing. Analysis related to rural credit is often part of policy papers that cover a broad range of rural development issues. As a result, during the last year, according to the author's knowledge, no scientific papers about rural finance in Croatia, or analysis, were produced.

## **1.3 Access to rural credit – uptake and issues**

The supply of agricultural loans in Croatia is much weaker, compared to total credit offer. Agriculture rarely appears in strategies of commercial banks in Croatia. That is the result of a generally strong credit demand that enables bank concentration on less risky investments.

Insufficient farm and business management skills, the lack of viable investment opportunities and feasible project proposals, inadequate institutional support services (research and new technologies, extension service), collateral issues, plus poor agricultural input, equipment supply, market information systems and market structures, make farmers face serious

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<sup>2</sup> Operational Plan of Implementation of Program of Development of Cattle Production

difficulties in having access to loans. Therefore, they are forced to finance themselves on their own resources.

According to the Farm Survey<sup>3</sup>, traditional “fear” of farmers to use and apply for credit is evident. Also, farmers have insufficient information and knowledge on sources and conditions of credit. Rural finance infrastructure is still poor, together with an inadequate supply of bank credit. Farm Survey results show a low access to production credit. Out of 892 farms only 205 farmers decided to use credit in order to finance their farm production in 1999. The average credit amount per farmer was Kuna 78,000 (table 1- Appendix).

The unresolved legal and organizational status of family farms makes them unattractive to financial institutions. Therefore, banks prefer to lend money to legal persons<sup>4</sup> in agriculture. Farmers and other entrepreneurs in rural areas share one important feature that keeps them away from external sources of finance, and this is the lack of business ideas and entrepreneurial spirit.

The issue of loan collateral deserves special attention in rural finance. Bank collateral requirements are high and expensive for borrowers and, on the other hand, they often don't give sufficient protection to banks. A basic paradox hampers the use of collateral in Croatia (Kraft, 2001). Banks require high levels of collateral because they know that foreclosure is difficult to attain, and more collateral is required from clients that are considered a greater credit risk. In particular, banks use collateral as a major element in their lending decisions. Certainly, requiring “excess” collateral may help a bank to cover the extra costs related with long waiting periods for court decisions. However, apart from using collateral as a screening measure, to keep away unwanted clients, it is not clear what is accomplished by demanding high collateral, if in the end eventual foreclosure is expected to fail. The main causes for this situation are the problems in the court system and ineffective court enforcement. A current inadequate legal framework, such as inefficiencies in bankruptcy procedures, and a lack of financial control mechanisms, emphasize the problem of loan collateral.

Collateral problems with agricultural land are mainly related to a non-functional land market, a lack of effective land ownership registration, and to state land. As mentioned earlier, family farms in Croatia are small and fragmented. The reasons for that situation arise from: (a) inappropriate succession legislation, (b) a relatively large share of remaining state land (about 1/3), (c) An underdeveloped land market due to an ineffective cadastre and land register, and related bank loan collateral problems, and (d) fragmented land parcels and lack of adequate infrastructure (access roads, drainage systems).

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## **Availability and performance of rural credit facilities**

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### **2.1 Assessment of short-term credit sources**

The main sources of finance for farmers are:

- a) The financial sector (commercial banks, saving and credit cooperatives)
- b) Government and public government sponsored agencies

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<sup>3</sup> The Farm Survey"(1998.-2001) project aims primarily at collecting annual data about the economic situation of family farms. The survey sample encompasses 892 family farms and covers all agricultural regions in Croatia.

<sup>4</sup> Legal persons = units registered in the Croatian Register of Business entities which refers to trade companies, enterprises, institutions, co-operative, associations and government bodies.)

- c) Trade credits
- c) Others (international development and donor institutions)

There are 34 commercial banks in Croatia and, according to a phone survey and web-site research, 9 of them have specific farm loans in their standard credit offer. Besides these, other banks occasionally finance the agricultural sector, usually by cooperation with local government units. Commercial banks that offer specific allocated loans to farmers mainly have traditional regional economic cohesion with agriculture. For example, the richest credit offers come from banks with local importance or banks that incorporated previously farm-orientated banks. Smaller banks have developed credit lines for farmers because they are not competitive to larger banks in other credit services as, for example, housing loans. Two of the most important banks for agricultural financing are Erste banka and Croatia banka. Based on information from annual reports, during 2005 the amount of total agricultural loans of Erste banka was 237 million kunas i.e. 1.2% of its total credit portfolio. In 2004 Croatia banka granted 48 million kunas of agricultural loans i.e. 6.9% of its total credit portfolio. Savings and Credit Corporations are relatively unimportant segments of rural finance and sources of short term credits.

In Croatia there is no legal act for regulation of the business operations of micro-finance organizations (MFO). At the end of 2002 there were some government initiatives to regulate the existence and activity of micro-financial organizations, but during 2003 these initiatives were rejected by the Croatian parliament. The cause of rejection was a more stable bank system with a richer loan offer than the one in countries with developed micro-financial institutions. Because of those reasons, majority of members of Croatian Parliament Board considered MFO unnecessary. (source: Report from Croatian Parliament Board session, Vjesnik, 29<sup>th</sup> January 2003).

In a practical sense, micro- financial organizations in Croatia operate informally, as in the Savings and Loan Cooperatives (S & L). The operation of S & L is regulated by the law on S & L (2002). There were only three larger initiatives (supported by international donor organizations) that were trying to conduct micro-financing programs in Croatia. Two of them were supported by Open society institute and International Catholic Migration Commission (ICMC). They were established as Savings and Loan Cooperatives - NOA and DEMOS. The third initiative was supported and maintained by Catholic Relief Services (CRS). It was established as foreign society in Republic Croatia with special approval by Croatian National Bank. Because of legal limitations and impossibility to launch their own credits, CRS gives loans by arrangement with commercial banks.

Although it is difficult to estimate the volume of agricultural trade finance, short- term trade credit arrangements and input supplier credit are of great importance to farmers. Agricultural input supply companies are slowly reaching the former levels of trade credit as in the time of the former 'agrokombinats', which were, and partly still are, the main suppliers and buyers of farm products. War, economic reforms, and privatization have hardly influenced their business. Trade credit is relevant to a large number of farms in the dairy sector (65,000 farms), tobacco production (2,200 farms), and sugar beet production (10,000 farms,) while significant numbers of family farms are engaged in poultry production, and cattle and pig fattening. Cooperatives with some 50,000 members are also important providers of trade credit.

Establishing a system of warehouse receipts for grain and oil seed crops would probably improve access to short-term credits.

## **2.2 Assessment of medium-term and long-term credit sources**

Commercial banks provide medium and long-term loans for the following purposes:

- Loans for livestock production, stable construction and equipment purchase.
- Loans for agriculture mechanization purchase.
- Loans for the establishment and maintenance of orchards and vineyards.
- Loans for vegetable growing, floriculture, mushroom-growing and beekeeping.
- Loans for buying private or state owned land.

Support for capital investments through the Model of Capital Investments can be approved for medium-term (at least two years) and long-term credits in agriculture, fishery and forestry. Furthermore, the majority of commercial banks finance tourism sector investments. That incorporates investments in rural tourism. Besides commercial banks, The Croatian Bank for Reconstruction and Development (CBRD), entirely owned by Croatian Government, also participates in agriculture financing. CBRD credit conditions are significantly more advantageous than commercial banks but not diversely purposed. Currently, the implementation of programmes of financing cattle production and the establishment of perennial plantation is in progress in Croatia. The Ministry of Agriculture, Forestry and Water Management, The Croatian Bank for Reconstruction and Development and the Croatian Agency for Small Business are all included in this project. The disadvantages of these credits are their restricted purposes and complicated and prolonged procedures.

To improve the competitiveness of rural areas, a wide range of programmes (grants but mainly subsidized credits) have been launched. The Ministry of Economy, Labor and Entrepreneurship subsidises different credit lines for entrepreneurs and co-operatives. Targeted groups, such as veterans of the Patriotic war, women and youth haven't been neglected in that sense.

Other ministries as well as local government are often involved. Finally, the main features of these programmes are the lack of coordination, and inefficient communication with prospective clients.

## **2.3 Assessment of the adequacy of credit sources**

Commercial banks' credits in agriculture have an average interest rate of 8.1% (measured as an average of all agricultural loans). Depending on the purpose, interest rates range between 7% and 10 %. The highest interest rates are for the short-term credits loans aimed to the financing of sowing, whereas the credits with the lowest interest rates are long-term loans for livestock purchasing. Repayment periods depend on the financing purpose. The longest repayment period is 10 years, and these credits are very often arranged with a 2 years grace period. As capital redemption, a first mortgage, loan bill and debenture, deposit by government subvention of capital investments, guarantee of the Croatian agency for a small business (HAMAG) and credit guarantor are all used. Banks also require credit recipients to operate within the system of value added tax or to have long-term agreements to sell milk for the milk industry.

Saving and credit co-operatives provide mainly short-term loans. They lend to family farms a maximum of 20,000 Kuna, and to cooperatives between 50 to 100 thousand Kuna. Interest

rates are between 8.99% and 11.99%, and the fee for credit arrangement is 3.0%. The repayment period is 3 years maximum. Operational plans loans have especially favourable interest rates of 4 per cent, long repayment periods of up to 15 years, grace periods and other privileged conditions.

Operational plan	Perennial crops	Cattle
Purposes	Investments in establishing new plantations, buying agricultural land, machinery and equipment,	Investments in buildings, livestock, equipment and agricultural land
Repayment period	Olive groves: 15 years including grace period (5 years) Investments in existing orchards: 10 years including grace period (2 year) Other investments: 12 years including grace period (3 years)	12 years (including grace period)
Grace period		2 years
Interest rates	4%	4%
Max amount of a loan	1,5 million kunas (natural persons*) 3,5 million kunas (legal persons**)	3,5 million kunas
Entitled to borrow	Family farms, trade companies, craftsmen, cooperatives	Family farms, trade companies, craftsmen

\*- Natural person = a natural entities that perform activities in line with the law and refer to the crafts and freelances. By the Croatian low, family farms are physical persons.

\*\* Legal persons = units registered in the Register of Business entities which refers to trade companies, enterprises, institutions, co-operative, associations and government bodies.

Source: Croatian Bank for Reconstruction and Development; [www.hbor.hr](http://www.hbor.hr)

Due to the problem of differentiating between disbursed funds for rural areas and rural activities, and those for urban areas, we analyzed them together. In the recent past and today also, the Ministry of Economy has been the main source of credits for SMEs. Their programs represent a combination of directed public funds and commercial bank credit.

In all the mentioned credit sources it seems that interest rates are not a problem. The problems are collateral, lack of business history (book-keeping data - especially for family farms), and sometimes the lack of clear presentations of business ideas through business plans.

## 2.4 Evidence of credit market failure

The market failures of agricultural risk sharing instruments in the transition economies of Central and Eastern Europe restrict potential for efficient risk management and consequently generate highly uncertain business environment. Agricultural insurance is undeveloped in Croatia, and agricultural statistics show a low relevance of crop insurance and a small land area covered by insurance. Actually, according to collected information, only a few insurance companies deal with agricultural insurance (crop insurance against unfavourable weather condition and livestock insurance). Premiums for crop insurance are high, and because of that most farmers do not use insurance. Apart from hail insurance, other forms of agricultural insurance products and hedging instruments are of limited supply. Additionally, risk and low profitability often constrain external fund inflows, influencing fewer investments and deteriorating a farm's income stability and competitiveness.

**Overview and prospects**

Some recommendations for the rural finance sector include the need for the mobilisation of savings, and providing flexible and safe savings deposit facilities for the rural population. Saving and credit co-operatives should be developed to the level that will enable the provision of quick and reliable services or even better lending terms than banks. Establishing a loan guarantee fund on a local or national level, plus establishing a functioning land market and an effective legal framework should improve the situation with regard to the need for collateral, while appropriate training programmes in rural finance for commercial banks and farmers could enable a better understanding on both sides.

The Government could give more attention to enabling and improving the existing extension service, especially in approaching EU pre-accession funds. It is also necessary to foster scientific research in the rural finance sector, on both a macro and a micro level.

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APPENDIX

**Table 1: Credit to family farms (in Kuna), Year 2000**

Regions	All family farms (N= 892)		Family farms with credit (N= 203)	
	Average Loan Size	Ratio of Value of Credit/Value of Total Assets (%)	Average Loan Size	Ratio of Value of Credit/Value of Total Assets (%)
Pannonian A	25,438	5.66	100,520	17.20
Pannonian B	27,063	6.64	140,954	21.96
Hilly-Mountain	34,941	6.69	102,326	14.26
Mediterranean	26,170	2.71	100,062	11.93
Total, Croatia	27,276	5.80	119,852	18.60

Source: Farm Survey data

**Table 2:** Provisional unaudited data of business results of commercial banks, December 31st 2005

	<b>Bank</b>	<b>Total Assets (000 HRK)</b>	<b>Share in Total Assets (%)</b>	<b>Assets growth (%)</b>	<b>Profit/loss before taxation (000 HRK)</b>
1.	BANKA BROD d.d.	188.767	0,07	24,76	5.346
2.	BANKA KOVANICA d.d.	696.689	0,27	23,11	2.522
3.	BANKA SONIC d.d.	798.462	0,31	32,67	20.443
4.	BANKA SPLITSKO-DALMATINSKA d.d.	150.285	0,06	5,10	3.465
5.	CENTAR BANKA d.d.	837.317	0,32	25,08	12.478
6.	CREDO BANKA d.d.	1.013.748	0,39	26,07	13.219
7.	CROATIA BANKA d.d.	1.461.031	0,56	-2,55	5.768
8.	ERSTE & STEIERMÄRKISCHE BANK d.d.	30.435.625	11,68	17,87	436.408
9.	GOSPODARSKO KREDITNA BANKA d.d.	374.888	0,14	8,12	12.407
10.	HRVATSKA POŠTANSKA BANKA d.d.	7.306.863	2,80	31,72	116.499
11.	HVB SPLITSKA BANKA d.d.	23.411.641	8,98	9,03	353.737
12.	HYPO ALPE-ADRIA-BANK d.d.	19.287.256	7,40	12,93	250.062
13.	IMEX BANKA d.d.	600.277	0,23	16,24	7.720
14.	ISTARSKA KREDITNA BANKA UMAG d.d.	1.701.565	0,65	8,58	27.116
15.	JADRANSKA BANKA d.d.	1.647.322	0,63	4,68	4.477
16.	KARLOVAČKA BANKA d.d.	1.130.865	0,43	-7,05	10.152
17.	KREDITNA BANKA ZAGREB d.d.	913.411	0,35	7,91	11.746
18.	KVARNER BANKA d.d.	338.698	0,13	17,41	7.348
19.	MEĐIMURSKA BANKA d.d.	2.207.260	0,85	6,68	38.103
20.	NAVA BANKA d.d.	363.815	0,14	0,68	3.533
21.	OTP BANKA HRVATSKA d.d.	8.712.751	3,34	10,32	170.666
22.	PARTNER BANKA d.d.	1.031.059	0,40	28,39	26.281
23.	PODRAVSKA BANKA d.d.	1.802.929	0,69	15,69	19.192
24.	POŽEŠKA BANKA d.d.	375.531	0,14	-8,62	-50.334
25.	PRIMORSKA BANKA d.d.	112.213	0,04	13,49	108
26.	PRIVREDNA BANKA ZAGREB d.d.	47.872.582	18,37	16,42	925.302
27.	RAIFFEISENBANK AUSTRIA d.d.	28.680.039	11,01	17,55	369.782
28.	SAMOBORSKA BANKA d.d.	329.635	0,13	4,27	2.544
29.	SLATINSKA BANKA d.d.	863.342	0,33	11,56	12.471
30.	SLAVONSKA BANKA d.d.	7.166.917	2,75	29,26	72.355
31.	ŠTEDBANKA d.d.	917.820	0,35	4,68	37.687
32.	VABA d.d. BANKA VARAŽDIN	311.548	0,12	122,33	8.415
33.	VOLKSBANK d.d.	3.940.277	1,51	8,91	27.884
34.	ZAGREBAČKA BANKA d.d.	63.611.229	24,41	10,68	1.126.536
	<b>TOTAL</b>	<b>260.593.659</b>	<b>100,00</b>	<b>13,64</b>	<b>4.091.438</b>

Source; Croatian National Bank, [www.hnb.hr](http://www.hnb.hr)

**Table 3:** Number of banks in Croatia (1993-9/2005)

	<b>State owned banks</b>	<b>Private domestic banks</b>	<b>Foreign owned banks</b>	<b>Total</b>
<b>1993.</b>	25	18	0	43
<b>1994.</b>	26	23	1	50
<b>1995.</b>	14	39	1	54
<b>1996.</b>	10	43	5	58
<b>1997.</b>	7	46	7	60
<b>1998.</b>	8	42	10	60
<b>1999.</b>	10	30	13	53
<b>2000.</b>	3	20	20	43
<b>2001.</b>	3	16	24	43
<b>2002.</b>	2	21	23	46
<b>2003.</b>	2	20	19	41
<b>2004.</b>	2	20	15	37
<b>9/05.</b>	2	19	13	34

Source: Bulletin about Banks, No 11, Croatian National Bank, 11/2005

**Table 4:** Banking system by ownership

in % of Total Assets	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>9/05</b>
<b>State owned banks</b>	5,7	5,0	4,0	3,4	3,1	3,4
<b>Private domestic banks</b>	10,2	5,6	5,8	5,6	5,6	5,5
<b>Foreign owned banks</b>	84,1	89,3	90,2	91,0	91,3	91,1

Source: Bulletin about Banks, No 11, Croatian National Bank, 11/2005

**Table 5:** Concentration index - share of assets of the 2(4) largest banks in total bank assets

in %	<b>Two largest banks</b>	<b>Four largest banks</b>
<b>1995</b>	54	68
<b>1996</b>	46	60
<b>1997</b>	40	53
<b>1998</b>	41	53
<b>1999</b>	44	58
<b>2000</b>	48	62
<b>2001</b>	46	60
<b>2002</b>	44	59
<b>2003</b>	43	62
<b>2004</b>	43	65
<b>9/05</b>	43	65

Source: Bulletin about Banks, No 11, Croatian National Bank, 11/2005

**Table 6: Credit terms of agricultural loans by Croatian financial institutions**

	<b>Erste banka (Commercial bank)</b>	<b>Croatian Bank for Reconstruction and Development</b>
<b>Max. credit limit</b>	<b>Determined by credit worthiness</b>	<b>3,5 million HRK</b>
<b>Repayment period</b>	<b>max 10 years</b>	<b>max 12 years</b>
<b>Interest Rate</b>	<b>7,5% - 8,5%</b>	<b>4%</b>
<b>Loan fee</b>	<b>1,0% - 2,0%</b>	<b>1%</b>

Web site: [www.erstebank.hr](http://www.erstebank.hr)  
[www.hbor.hr](http://www.hbor.hr)