

## **Croatia Debt Market Assessment**

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# CROATIA: EXPEDITED BOND MARKET ASSESSMENT

## 1. Issuers of and Investors in Debt Instruments

### A. EXISTING ISSUERS AND INVESTORS

Government bonds dominate Croatian bond market. The bond market is moving slowly towards a more balanced mix of public sector, quasi-government and private sector bonds.

The main debt issuers in Croatia are the state itself, the state funds and agencies, and since 2002 for the first time - corporations. As of early 2003, the Ministry of Finance (Republic of Croatia) had three domestic bond issues outstanding,<sup>1</sup> with a total face value of EUR 500 million. The State Agency for Deposit Insurance and Bank Rehabilitation (DAB) has issued two bond series: DAB 003 and DAB 005. The state health authority (HZZO) has one issue outstanding: HZZO. These issues are all coupon bonds. There is only one discount bond issued by another state fund (FNOI), denominated originally in German marks, since it has been issued before the introduction of euro.

Two corporations that issued bonds belong to the tourism and paper sectors. Plava Laguna is a tourism company with revenues of HRK 323 million (about \$3.2 million-equivalent) in 2001, and profits of HRK 51 million (less than US\$500,000) in 2001. (Together with Riviera Poreč, it is the most important tourism entity in Croatia.) The second is Belišće, the largest paper and cardboard producer in Croatia, with 2001 revenues of HRK 676 million (about \$6.6 million) and profits of only HRK 7 million (less than \$70,000). These two examples suggest that bonds can be floated in domestic markets, despite comparatively low revenues and profits when compared to major markets around the globe.

#### Existing Issuers in the Croatian Bond market

SYMBOL	ISSUER	NOM. VALUE (EUR)	ISSUE VALUE (EUR MN)	NOMINAL INTEREST RATE	ISSUANCE DATE	MATURITY
<b>DAB-O-03CA</b>	Državna agencija za osiguranje štednih uloga i sanaciju banaka	1	105	8,000%	19.12.2000.	19.12.2003
<b>DAB-O-05CA</b>	Državna agencija za osiguranje štednih uloga i sanaciju banaka	1	225	8,375%	19.12.2000.	19.12.2005
<b>HZZO-O-047A</b>	Hrvatski zavod za zdravstveno osiguranje	1	222	8,500%	17.7.2000.	19.7.2004
<b>RHMF-O-049A</b>	Republika Hrvatska	1	200	6,500%	20.9.2001.	20.9.2004
<b>RHMF-O-08CA</b>	Republika Hrvatska	1	200	6,875%	14.12.2001.	14.12.2008
<b>RHMF-O-125A</b>	Republika Hrvatska	1	500	6,875%	23.5.2002.	23.5.2012
<b>BLSC-O-051A</b>	Belišće d.d.	1	17	7,375%	17.1.2002.	17.1.2005

<sup>1</sup> RHMF 004, RHMF 008, and RHMF 012 – issued in three tranches: first, in April 2002; second in September 2002; and third, in January 2003.

<b>PLAG-O-048A</b>	Plava laguna d.d.	1	12	6,750%	5.2.2002.	25.8.2004
<b>FNOI*</b>	Fond za naknadu oduzete imovine	10 DEM	120 million	-		Annuities, the last matures on 01.07.2019.

Source: The ZSE monthly and quarterly Reports

### **Description of investors that bought the debt offerings:**

Institutional investors (pension funds, insurance companies), banks, other corporations, individual investors, and foreign investors. (See appended Table 1.)

The major investors in bonds in Croatia are institutional investors. This includes open– end funds, closed –end funds; and since 2002, obligatory pension funds (which are not state-owned). There are 19 open-end funds, created predominantly by banks. There are also six closed-end funds, mostly created during the voucher privatization process. There are also two privatization investment funds and seven pension funds in Croatia.

There are also 23 insurance companies. The insurance industry in Croatia is underdeveloped, and has no significant impact on the financial sector as an institutional investor. Thus, it does not play a major role in the Croatian bond market.

Banks are also important investors in bonds. Furthermore, banks have an underwriting role, acting as an agent in the issuance process.

### **Characteristics of instruments issued**

All bond issues are denominated in euros, with all the payments made in Croatian kunas, according to current Croatian National Bank exchange rate. The nominal value of one bond is 1 euro, with no exception. The range of government bond issue size is from 105-500 millions of euros. Corporate bond issues are much smaller, equalling 12 and 17 millions of euro for Plava Laguna and Belišće, respectively. The existing issues' maturity range is from three to ten years. Issues have been made by public offer, intermediated by banks, all in the domestic market.

### **Characteristics of issuance and underwriting process**

Banks that have arranged issues have also directly underwritten the very same issues. Offers are outstanding for 30 days maximum, according to the Securities Law. There is no rating agency in Croatia.

## **B. PROSPECTIVE ISSUERS AND INVESTORS OF DEBT INSTRUMENTS**

### **Description of likely candidates for issuance**

First, in Croatia, there are no municipal issues. The counties could securitize their debts, but municipal issues are generally small, without guarantee, and they lack a secondary market. With proper incentives, cities could place their bond issues on the market, but those issues have similar risks as county issues. The major part of the public debt is issued by the central state. The potential problem is the lack of transparency, and the fact that city potential is not adequately rated. The second problem is fiscal centralization. Together with decentralization, the local units' capacity could increase enough to enable them to issue municipal bonds.

Mortgage bonds would be very interesting, but it is considered that the Croatian market is not yet mature enough to absorb them. However, the Croatian mortgage loan market has grown in recent years, which makes mortgage bond or mortgage-backed securities issues more feasible.

Corporate bonds are estimated to have a great future on the Croatian market. The only Croatian bank that has been a corporate bonds' agent in Croatia to date is Privredna Banka Zagreb (PBZ), now owned by [Unicredito] (Italy). The attitude of the PBZ corporate finance experts, and their advice to corporations, is to "test" the market by issuing short-term debt instruments prior to any long-term debt issuance. This occurred in the case of Plava Laguna, the second corporate bond issuer in Croatia.

#### Description of likely candidates to purchase the issues

For this year, the pension funds' supervisory bodies have announced certain investment liberalisation, especially regarding investments in municipal and corporate bonds. The pension funds started their activities in April 2002. Their return in 2002 was around 15% (annualized basis).

#### **Types of instruments that might be offered**

Short-term (less than 5 years), and medium-term (10 years) bonds, in foreign currency (euros), already exist. There is a strong need for kuna-denominated instruments.

There is a correlation between low inflation rates and long-term debt. It is estimated that, with the current inflation rate, instruments with longer maturities could be issued.

Instruments with longer maturities could help to decrease the amount of credit corporations and other entities borrow from banks. In other words, this would help with overall financial sector diversification, rather than traditional reliance on banks for formal financing.

The Croatian debt market should develop a wide range of instruments, which would minimize the issuers', and the investors' exposure to various risks, including foreign exchange risk. Risk exposures could be effectively hedged in liquid markets. The Croatian bond market is rather liquid, and in terms of volume it is, in some periods, larger than the stock market.

#### **Characteristics of issuance and underwriting process that may be required in terms of intermediation**

According to the Securities Law, there is a possibility of private and public placements. In the case of private placements, the securities must be offered to institutional investors, the shareholders, or to the issuer's employees, and up to 20 external investors. The offer can be outstanding for three months. In Croatia, banks often act as underwriters. The growing institutional demand would increase the possibility of private placements (e.g., to the pension funds).

### **C. BACKGROUND ON INVESTOR DEMAND**

Institutional investors can invest in private debt issues, although there are certain limits. For example, a maximum of 30% of all pension funds' investments can be placed in municipal and corporate bonds.

Since the banking crisis (1998-99), the banking system has been restructured. Banks in Croatia were, during the last few years, all taken over by foreign bank groups. The exception is Hrvatska Poštanska Banka, with major Croatian (state) ownership. Secondly, many foreign (predominantly Austrian) banks have entered the Croatian market. The last bank crisis was in March 2002, when the CNB intervened in Riječka Banka. In the beginning of 2002, almost 90% of banks' assets were held by banks with majority foreign ownership. Smaller banks are focused on certain regions. The three largest banks, Zagrebačka Banka, Privredna Banka Zagreb and Raiffeisen bank, held, in September 2002, a total of 53% of all banking sector assets. The Herfindahl index shows a high degree of bank concentration.

Other main institutional investor groups are investment funds (closed-end and open-end), pension funds and insurance companies, together with corporations. As noted above, insurance companies play virtually no role as investors. Pension funds have been active over the last year.

The closed-end funds invest in bonds, but the major part of their portfolio consists of stocks obtained in the voucher privatization process, together with newly acquired stocks. Their investment strategy is not focused on bonds. However, the fund industry in Croatia is rapidly developing.

Pension funds are also concentrated. More than 95% of all assets and all insured persons belong to three pension funds, the A-Z Fund (founded by Zagrebačka Banka and Allianz), PBZ – Croatia Osiguranje (founded by Privredna Banka Zagreb and Croatia insurance), and Raiffeisen obligatory pension fund (founded by Raiffeisen Bank).

## **2. Capital Market Setting for Bond Markets**

### **A. LEGAL AND REGULATORY SETTING FOR DEBT ISSUANCE**

The Securities Act, amended in the middle of 2002, regulates the primary and secondary market. The Securities Commission of the Republic of Croatia (CROSEC) is the agency responsible for securities supervision and regulation. The companies that issue bonds must comply with the Rules imposed by CROSEC. Among other rules, they must have audited reports for the last three years.

The disclosure requirements are considered to be insufficient. When a company issues debt by private placement, an Invitation to the selected group is required. However, the company has no obligation to make public the information, as if it was a public placement, which requires a Prospectus. The company faces a trade-off: it can avoid disclosure requirements (in the Prospectus) by placing an issue by private offer.

At the moment, banks play the major role as arrangers, issue agents and dealers, and also as underwriters.

### **Tax issues related to the issuance and trading of securities**

According to the Laws, neither debt interest nor capital gains are taxable. There is no discrimination, since this does not depend on the issue type.

Accounting/audit standards that apply to debt issues

Croatia has accepted IAS as the main standard. There is a certain “compliance gap”, according to the observance of some foreign expert groups (IMF).

## **Regulatory/Supervisory oversight**

The CROSEC is the main supervisory body, but its effectiveness is considered to be insufficient. The exchanges play a limited role in supervision, although they are permitted to impose stricter rules than those imposed by the CROSEC.

## **B. INFRASTRUCTURE**

### **Depository system, clearance and settlement**

The SDA—Central Depository Agency of Croatia—has the role of clearing and settlement. It is considered to be efficient, safe and effective. The settlement period is T+4. Two systematically important payment systems are HSVP – the Large Value Payment System, and NKS – the National Clearing System, both of which are considered modern and reliable. All bonds are registered and maintained in the Depository.

### **Trading systems**

Bonds are listed and traded on the secondary market in the Quotations of Varazdin and Zagreb Stock Exchange.

### **Trade information and transparency/timeliness of information dissemination**

Institutional investors are allowed to make “pre-agreed transactions” with debt instruments (e.g., bonds). But, before the end of the trading day, the transaction must be reported to the Stock Exchange, together with details about the price and volume. The stock exchanges publish daily, weekly, monthly, quarterly and yearly trading reports.

### **Role of enhancements (guarantees, insurance, back-up lines of credit)**

[There is little/nothing available on this matter.]

### **Role of regulators and self-regulatory organizations**

The main regulators are CNB, which regulates banks and oversees the payment systems, and CROSEC – Croatian Securities Commission. CROSEC has limited authority over surveillance, and even less over inspection and investigation. Both exchanges have a certain self-regulatory function, but their market surveillance is quite limited. The regulators are occasionally opposed when trying to exercise their authority, mostly because of the lack of clarity of the laws. CROSEC should have better coordination with other regulatory authorities in the financial system.

### **Role of credit rating agencies, and their capacity/competence**

In Croatia, there is no rating agency. The external rating agencies have rated Croatian debt issues placed on foreign markets. Croatia is at the low end of the investment rating (BBB-), and among the cities, Zagreb is the only one that is rated.

### **Research capacity**

[There is little/nothing available on this matter.]

## **C. ACTIVITY**

### **Size of the equity market**

As of late 2002, there were 2,076 publicly registered companies in Croatia. Among these, 380 were listed on an exchange. Market capitalization was estimated to be about K47.3 billion, or about \$6.6 billion, and equivalent to about 28 percent of GDP for 2002 annualized. There is significant concentration in market value, as the top 10 listed firms account for about 70% of total market value. In particular, concentration characterizes the Zagreb stock exchange, where the top 10 firms are 83% of value. This has been true for years, with the 1997-2002 average at 87% and very little fluctuation.<sup>2</sup> Market turnover has increased slightly in recent years, but remains low at 1.5% of GDP. In 2002, there was only \$355 million-equivalent in trading. (See appended Table 2.)

### **Size of the debt market**

There is virtually no commercial paper market to review. Data are not available prior to 2002. As of the end of 2002, there were three commercial paper issues outstanding, equivalent to K82 million in value, or only \$11 million. This comes to an average of \$3.7 million per issue. As noted above, there were only two outstanding corporate note and bond issues as of end 2002, equal to about EUR 29 million in value. There were no data for corporate notes/bonds in the private placement market, nor for sub-sovereign or municipal bond issues. (See appended Table 3.) All together, Government-issued debt accounts for 98% of the total debt market in Croatia.

## **3. Macroeconomic and Financial Sector Setting**

### **Economic growth**

GDP growth in real terms was estimated to be about 3.5% in 2002, the third consecutive year Croatia has experienced real growth after a temporary slowdown in 1999 when the country recorded negative real growth. The year-end CPI inflation rate was 2.7 percent, little changed from year-end 2001. Interest rates moved in differing directions in 2002. Overnight rates and long-term loan rates declined markedly, with the overnight rate dropping to a low 1.58 percent after being in double digits in 1998-99. However, short-term loan rates increased from 9.45% to 12.3%, their highest rates since 1999. There are no data for savings rates in Croatia. (See appended Table 4.)

### **Government debt market: size and turnover**

There were 6 sovereign debt issues outstanding as of end 2002. They were valued at EUR 1,452 million. This averages EUR 242 million per issue, and accounts for 98% of the debt market activity in Croatia. Turnover figures were not available.

### **Banking**

Figures for 2002 show that banking assets as a percent of GDP have shown considerable growth since 2001. End 2002 figures showed assets were about 84.5% of GDP, about the same as 2001 and up substantially from 65-70% from 1997-2000. Meanwhile, the CNB

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<sup>2</sup> The range has been 83%-90%.

discount rate declined to 4.5% by year-end after staying at 5.9% since 2000. Interest rate spreads increased substantially in 2002 after showing declines since 2000.<sup>3</sup> This is consistent with data that show rates applied to short-term loans increased. (See appended Table 6.)

#### **4. Challenges, constraints, and prospects for development of the domestic bond market**

##### **Challenges and constraints for issuers**

One of the priorities for the Croatian market is developing a stable, more transparent, and deeper debt market with longer maturities. The domestic public debt, all denominated in euros, is highly vulnerable of sharp movements of the exchange rate. Because all the payments are directly linked to the exchange rate, it is crucially important that monetary policy interventions maintain the kuna at a level stable rate. This, of course, also depends on fiscal management, as the central bank will intervene and tighten if price stability is challenged. Such tightening may stabilize the currency, but a resulting slowdown in the economy due to higher interest rates and investor concerns about fiscal mismanagement would clearly reduce bond market prospects.

EBRD has shown interest in helping municipalities issue bonds in Croatia. However, the municipalities are not liquid, nor do they have a large secondary market. A key constraint at the moment is the limited activity of long-term investors, such as pension funds or life insurance companies that do not have the same need for liquidity as many other financial market participants. They can buy “cheap” illiquid bonds (earning the liquidity premium), and sell highly liquid issues. The market will need more involvement by them to “liquefy” a municipal bond market.

*Some analysts claim that issues smaller than EUR 100 million are not viable. It is estimated that Croatian companies have the capacity for issues in the domestic market of EUR 30-50 million. However, other analysts believe small bond issues can be viable.*

##### **Challenges and constraints for investors**

It is considered that pension funds will play a crucial role in the development of the Croatian securities market in the forthcoming period. However, pension funds face many restrictions, imposed by the Law on Mandatory and Voluntary Pension Funds. It is expected that these restrictions will be loosened. Pension funds need large issues, since they must not invest their assets in more than 5% of one issuer’s securities.

A “young” pension fund, while it matures, needs large inflows. Pension funds may invest only in listed shares. In Croatia, only one share is listed on the Varazdin Stock Exchange (DOM-fund, closed-end fund), and three more on the Zagreb Stock Exchange. These are the shipyard Viktor Lenac, the pharmaceutical company Pliva, and the food company Podravka. It is evident that the pension funds’ investments in shares are highly restricted. If the pension funds were permitted to buy large shares of comparatively small domestic issues, it could create major distortions in the local market. That problem can be reflected in security pricing. The Croatian market is not very deep, and one large transaction at a certain price can move a security price upwards or downwards significantly.

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<sup>3</sup> IFS data show net loan to deposit spreads of 10.85% in late 2002.

### **Challenges and constraints for market infrastructure**

The exchanges have to continue harmonization of their rules and practices with EU directives. The exchanges and main regulators have to work on improvement of the supervisory system. Croatia would benefit from establishing a domestic (or regional) credit rating agency. The development of a repo market would be helpful in facilitating arbitrage across the yield curve.

According to an IMF assessment, the main tasks in the primary market include: (i) enhancement of the issue practices in terms of issuance frequency, announcements and introduction of new instruments; and (ii) in the secondary market, there should be a proper clarification of regulatory responsibilities for the market among the CROSEC, Ministry of Finance and the Croatian National Bank.

### **Prospects for the development of the bond market for corporations and banks**

It is considered that “second pillar” (mandatory, privately managed) pension scheme development will foster the bond market development in Croatia. Foreign experience (for example, Chile) shows that the bond market can be developed in parallel with the growth of second and third pillar pension fund schemes.

A key prerequisite for the development of a corporate bond market is the existence of credit risk assessment capacity. This comes from a number of different sources, including the private market, credit rating agencies, insurance specialists, risk management specialists, and regulators.