

BANKA KOVANICA d.d.

**Annual report as at
31 December 2017 together with the
Independent Auditor's Report**

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**BANKA KOVANICA d.d.
VARAŽDIN**

**ANNUAL REPORT OF THE MANAGEMENT BOARD ON
THE BANK'S POSITION
as at 31 December 2017**

Enclosed: audited financial statements as at 31 December 2017

Note of the Management Board

In 2017, the Republic of Croatia recorded economic growth for the third consecutive year, with a real GDP growth of 2.8%, with growth forecasts in 2018 and 2019, which remain unchanged at +2.8% and +2.7%: at this economic growth rate, the GDP value before the economic crisis is expected to be reached by the end of 2019. Consumption in both the private sector and the tourism sector remain the main drivers of development, which are favourably affected by the increase in personal income and employment rate that boost available income and family confidence. In 2017, the dynamics of private investments is affected by the extraordinary administration procedure that is underway over the largest group in the Republic of Croatia: the final effects of debt restructuring or other settlement arrangements are still not known; moreover, a moderate growth of investments is anticipated due to easier access to funding sources by entrepreneurs. Export in the net amount has been increased due to the economic growth of EU member states, albeit limited by the growth of imports due to increased domestic demand. In 2017, the inflation rate was 1.2% driven by energy and food prices, with growth forecasts up to 1.6% in 2018. The public deficit of the state is estimated to be below 1% in relation to the GDP with public debt remaining below 80% of the GDP, which is within the average amount in the Eurozone. In 2018, the rating of the state has improved to “BB +” (Fitch), which is still below the investment grade, but with a stable or positive forecast by all three major international rating agencies.

In 2017, the Croatian banking system recorded a normalised pre-tax profit of HRK 4.15 billion (provisional data, source CNB), down 32.8% compared to 2016, primarily due to increased value adjustments relating to the aforementioned group of systemic importance. In a relatively concentrated banking system (the first eight banks with assets exceeding 5% of total assets hold a combined market share of more than 90%), the Bank holds rank 21 in terms of total assets and equity (market share: 0.3%). In a

sample of 16 small banks with assets of less than 1% of total assets (average: HRK 1.8 billion), the Bank holds a market share of 4.1%. In 2017, this sample of small banks recorded a total loss of HRK 15.57 million, with 8 out of 16 banks recording a loss. The Bank recorded an operating and net profit of HRK 18.36 million or HRK 5.31 million: it should be noted that this result was affected by an extraordinary value adjustment of HRK 11.88 million to cover potential losses and total expenses related to a multi-year civil court dispute conducted with a company headquartered in the Republic of Croatia. The responsibility for this matter is held by the President of the Management Board who was in office at the time of initiating the legal dispute (FY 2009), to which the notes to the financial statements audited by external auditing companies have been referring since 2011. If we exclude, as a precaution, the effect of this extraordinary value adjustment regarding this dispute, which is under review, the net operating result would amount to HRK 17.18 million, well above the 2017 Business Plan, with a profitability indicator at the top of the European banking sector (pro-forma ROE: 15.4%), which is the peak of the Bank's restructuring process initiated by the Management Board in office since 2014.

Most important financial and business achievements:

- net operating results increased with the ROE profitability indicator of 4.8%, despite the extraordinary value adjustments due to the multi-year court dispute (which cannot be attributed, in terms of execution of the business plan, to the Management Board in office since 2014), thereby confirming the Bank's high level of profitability;
- the capital adequacy rate increased further to 17.3% (without retained regular operating profit), which confirms the appropriate level of capital strength in relation to the planned increase in lending volumes, primarily with respect to consumers and secondarily financing of working capital in the area of small and medium-sized enterprises;
- the amount of net due placements with maturity of more than 90 days is further declining, where the ratio of net placements due in relation to net equity and

additional equity instruments (Texas ratio proxies) is approaching 40%, which confirms that the loan policy is prudent and that doubtful receivables are being collected efficiently;

- the development of digital banking offerings along with the new Mobile Banking service after transitioning to a new information system as well as the cooperation with *fintech* companies by adopting new legal options starting from the area of advanced mobile payments (PSD2).

Further to the Bank's upcoming General Assembly, the net operating profit in the amount of HRK 5,307,774.65 arising from the audited financial statements of the company as at 31 December 2017 is proposed to be allocated to the company's reserves in accordance with the 2017-2020 Business Plan in order to increase the Bank's capital strength, converging towards the average values of the domestic banking system.

The Management wishes to thank all business partners, clients and shareholders for their trust as well as the members of the Supervisory Board for their cooperation and dedication. We also wish to thank the Bank's employees whom we would like to ask for extra effort to reach the challenging goals set out in the Business Plan.

General information on the Bank and organisational structure

The Bank has been operating continuously since 1997 when it was registered in the Registry of the Commercial Court in Varaždin as Štedionica Kovanica (savings bank). In April 2002, the savings bank was transformed into a bank and in 2005 it was granted a license from the Croatian National Bank (CNB).

The address of the Bank's registered office is in Varaždin, Petra Preradovića 29.

The share capital amounts to HRK 106,961,910.00, and is divided among 3,565,397 shares with a nominal value of HRK of 30.00, fully paid. The majority shareholder's share is 99.694% (Cassa di Risparmio della Repubblica di San Marino S.p.a.). The shares of private domestic shareholders comprise 0.3018%, while the Bank's treasury shares comprise 0.0042%.

The Bank is registered for the performance of the following business activities:

- accepting cash deposits,
- granting loans and other placements in its own name and for its own account,
- issuing electronic money,
- issuing guarantees or other warranties,
- factoring,
- finance lease,
- credit operations, including consumer credit, mortgage loans and financing of commercial operations (including forfeiting),
- trading in its own name and for its own account or in its own name and for a customer's account: in money market instruments and other transferable securities, foreign currencies including foreign exchange activities,
- trading in financial forward contracts and options, currency and interest instruments,
- performing local and international payments,
- collection of data, conducting analyses and providing information on the creditworthiness of legal and natural persons,
- representation in the sale of insurance policies, in accordance with the law regulating insurance, intermediation and representation in insurance activities,
- issuing and managing instruments of payment, intermediation in concluding financial deals.

The Bank joined SWIFT and the Croatian Credit Information Registry (HROK).

Shares are not listed.

The company's bodies as at 31 December 2017 are as follows:

General Assembly

Appointed at the assembly

President

Supervisory Board

Emanuele Restelli Prandoni Della Fratta

President

Ivan Majdak

Vice President of the Management Board

Pietro Giacomini

Member

Mladen Vedriš
Marino Albani

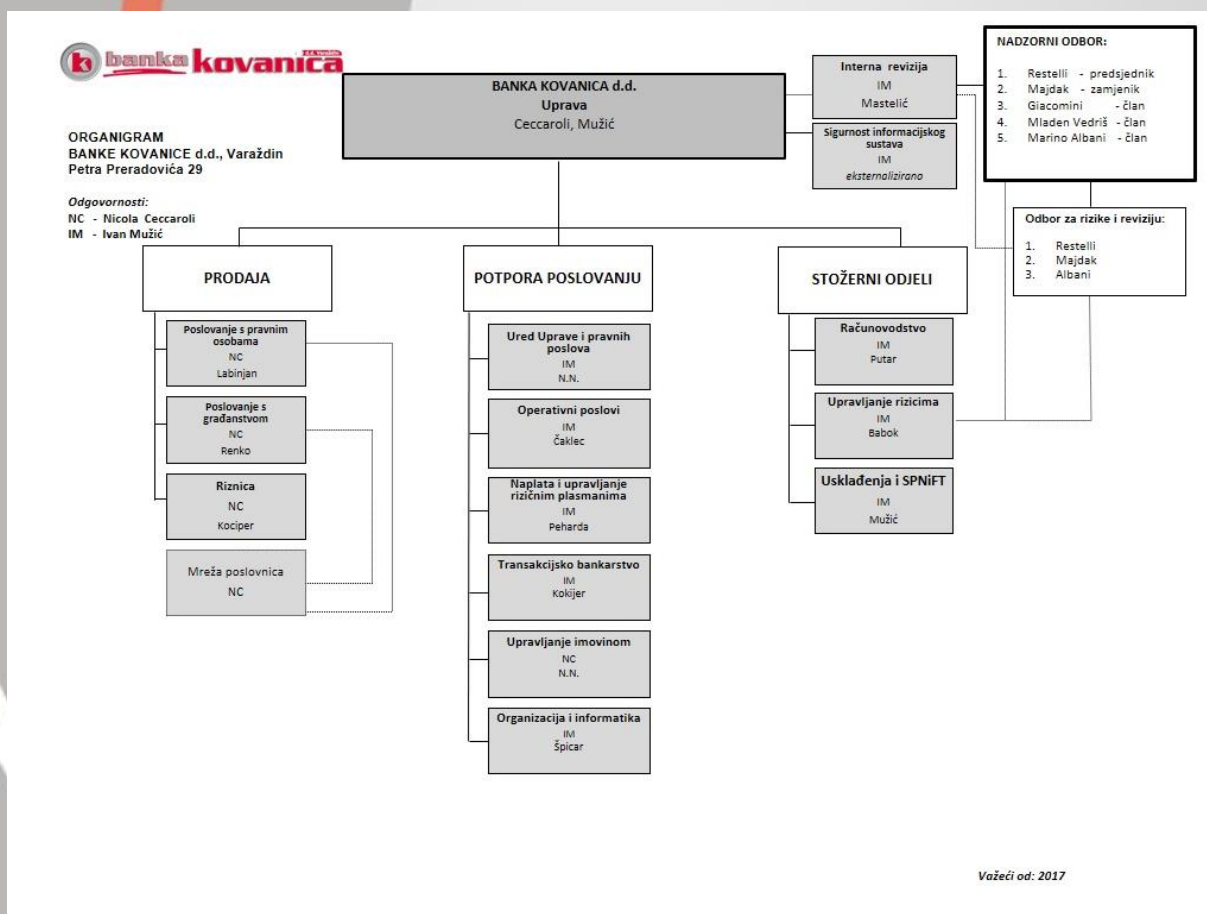
Member
Member

Management Board

Nicola Ceccaroli
Ivan Mužić

President
Member

The Bank operates through 12 branch offices and 10 ATMs on the domestic territory, offering services to citizens and legal entities, with a functional organisation based on Basel II requirements, the Credit Institutions Act, recommendations and guidelines of the CNB and on the basis of the specific needs of a modern bank. The Bank's Management Board remains in charge of further rationalisation of the branch network, taking into account digital banking, including the potential opening of a new branch office in the Istrian County where there is a lack of territorial presence, excluding future consolidation options between small and medium-sized banks.



The Bank's operations are managed by the Management Board consisting of two members with direct management responsibilities based on the separation of back and front office operations. Based on the scheme adopted in 2014, the Bank is organised in 6 Sectors and 7 Business Support Departments.

The consolidation of administrative services at the Bank's headquarters represents the basis of certain organisational changes intended primarily for the purpose of more efficient operational processes and reduction of operational risk:

- merging the Human Resources Department with the Management and Legal Affairs Department;
- merging the Departments for Payment Transactions, Treasury and Letters of Credit into a new Transaction Banking Department;
- the transfer of the FINA-filing order and Back Office (Payment) activities from the Loan Collection Department and Back Office to the Banking Transactions Department.

The Bank belongs to a group of smaller banks in a heavily concentrated banking market with the general license to perform all lending, billing and payment services in foreign currencies and receiving deposits, payment services and other financial services.

In July 2007, the Bank was taken over by Cassa di Risparmio della Repubblica di San Marino S.p.a, the oldest bank in the Republic of San Marino. In the course of its operations, the Bank's capital has been increased by the majority owner on several occasions, with the latest capital increase amounting to HRK 3.01 million (and a simultaneous dividend payment and capital reserves in the same amount) in line with the General Assembly's decision of 28 April 2017, which was entered into the Register of the Commercial Court in Varaždin, as a result of which the total share capital now amounts to HRK 106,961,910.00.

Human Resources

The Human Resources Department was established in 2009 and in 2014, it was merged with the Management and Legal Affairs Department. The Department is, among other

things, responsible for hiring new employees and ensuring that the employees' professional training assignments are met.

During 2017, the Bank hired 14 new employees, while 21 employees were dismissed, hence as at 31 December 2017 the Bank had 97 employees (2016: 104 employees) and as at 28 February 2018, it had 99 employees. As a rule, staff are generally full-time permanent employees. 6 employees are temporarily employed, mainly as a substitute for employees on maternity leave or because of a temporary workload increase in some offices. Excluding employees replacing those on maternity leave, the Bank's actual number of employees as at 31 December 2017 (FTE) is 91, of which the Total assets/FTEs ratio is up to HRK 12.58 million. The Management Board will continue to strive to further improve this efficiency index to bring it closer to the peer group's target values, through the optimization of back-office and middle-office staff as a result of the change of the banking information system.

Of the total number of employees (97) as at 31 December 2017, 76% of employees are women, the average age of employees is 40 years and 49% of employees are less than 39 years old.

49% of employees hold university degrees or senior titles, 23% hold bachelor's degrees, 28% have college education.

In 2017, the Bank had HRK 34,000 employee training expenses in terms of attending seminars and training courses, acquiring new knowledge, improving the quality of work and adjusting to legal changes, including periodic training within the Bank by responsible persons within individual Sectors.

Movements in the Bank's assets, financial results and the Bank's position

The audit of the Bank's financial statements was performed by an independent auditor - the auditing company PricewaterhouseCoopers d.o.o. The financial statements comprise the statement of financial position as at 31 December 2017, the statement of comprehensive income, the statement of changes in equity and the statement of cash flows for the year then ended, 31 December 2017, and notes to the financial statements.

After performing the audit of the financial statements, the independent auditor expressed their unmodified opinion for the third consecutive year.

As at 31 December 2017, total assets amounted to HRK 1,145.09 million, which is a 5% decrease compared to the previous year 2016: the cause of such decrease was primarily the decline in granting loans to clients from the Sector of Operations with Legal Entities, primarily due to the cancellation of all exposures, both direct and indirect, to the largest group of companies in the Republic of Croatia, which has been subject to an extraordinary administration procedure since April 2017.

As at 31 December 2017, the Bank's loan portfolio amounted to HRK 810 million, which is a decrease of 1%. Of this, loans to citizens increased by 12% and reached an amount of HRK 741.90 million, while loans to companies decreased by 55% and reached an amount of HRK 68.20 million, confirming the Bank's additional focus on lending to the retail sector.

Cash decreased by 6% compared to the previous year and amounted to HRK 155.47 million. CNB receivables also decreased by 8% compared to the previous year and amounted to HRK 64.48 million.

Available-for-sale financial assets decreased primarily due to lower exposure through short-term government bonds, while assets held to maturity decreased due to limited short-term financing through a discount of bills of exchange.

As at 31 December 2017, total Bank deposits amounted to HRK 948.36 million, and they account for almost all deposits of citizens, which represents a decrease compared to the previous year by 1%, taking into account the continuous decrease of the average interest rate on time deposits.

As at 31 December 2017, the Bank's regulatory capital amounted to HRK 140.38 million and the capital adequacy rate was 17.3% (excluding operating profit in 2017), which represents an increase compared to the planned amount and is above the minimum required amount (12%).

In 2017, the Bank extended the maturity term of a hybrid equity instrument with an institutional investor, which was concluded in 2015 in the amount of HRK 1.25 million in a way to recover the amortised amount of recognised capital.

The Bank's total interest income in 2017 was HRK 74.92 million, which is an annual decrease by 3%, while total interest expenses were decreased by 33% in 2017 compared to 2016, with a realised net interest income in the amount of HRK 58.96 million, representing an annual increase of 11% compared to 2016.

Commission and fee income amounted to HRK 7.59 million, which represents an increase of 14% compared to the previous period, while commission and fee expenses amounted to HRK 2.4 million, which represents an increase of 13% compared to the previous year. Net commission and fee income increased by 14% in 2017 compared to 2016.

Net other non-interest income amounted to HRK -14.51 million in 2017, compared to HRK -0.13 million in 2016. The reason for such decrease was primarily due to a provision of HRK 11.88 million due to the full coverage of possible losses in the above mentioned civil litigation.

General administrative expenses and depreciation/amortisation amounted to HRK 30.7 million, down 23% according to the cost-cutting policy over the last four years.

Value adjustments amounted to HRK 13.63 million, representing an annual decrease of 21%, resulting in operating profit of HRK 5.31 million. Taking into account the provision, which has been fully recorded as a precaution, with respect to the above mentioned multi-year legal dispute, which may generate income from the release of provisions after the completion of the audit or by direct settlement, the net operating result and the company's total pro-forma equity (before this extraordinary impairment by the entire amount that is not attributable to the Management Board of the Bank in office since 2014 in terms of business plan) would have amounted to HRK 17.18 million and HRK 128.83 million respectively, significantly exceeding the 2018 Business Plan, which anticipated net operating results in the amount of HRK 11.15 million and total equity of HRK 122.73 million.

Basic products and services of the Bank

1. Lending operations

With respect to lending operations with natural persons, the Bank offers several types of general-purpose loans. The Bank's clients have the following types of cash general-purpose loans available:

- general-purpose cash short-term loan with currency clause in Euros for the Bank's clients for a repayment period of up to 12 months;
- general-purpose cash long-term loan with a currency clause in Euros for a repayment period up to 180 months;
- general-purpose cash loan with a currency clause in Euros with a life insurance or life insurance with death benefit for a repayment period up to 120 months;
- general-purpose loans with a currency clause in Euros with residual value for a repayment period up to 144 months;
- general-purpose cash loan with a currency clause in Euros for retirees for a repayment period up to 60 months.

In its offer, the Bank adjusts loan terms and conditions to market requirements and competition.

General-purpose cash long-term loans with EUR currency clause have extended repayment periods up to 15 years and an increased amount to EUR 30,000.00.

The Bank also offers special-purpose loans, including mortgage loans with a repayment period up to 30 years.

2. Deposit operations

As part of deposit operations, the Bank offers a wide range of savings products with fixed and variable interest rates, demand and term savings, and individually approaches each client when defining terms and conditions. The Bank offers the following

savings products:

- Top-up term savings in HRK, HRK with currency clause and foreign currencies for periods from 1 to 60 months;
 - Profit term savings in HRK, HRK with currency clause and foreign currencies for periods from 1 to 60 months;
 - Perpetuity term deposits in HRK, HRK with currency clause and foreign currencies for periods from 1 to 60 months.
-

Since October 2015, the Bank offers term deposits to natural persons in the Federal Republic of Germany under the "EU Passport" regime in cooperation with SAVEDO GmbH (Deposit Solutions Group). The online platform manager and the banking partner together manage the entire customer life cycle in German (online/offline client acquisition, application form, customer service). The cross-border collection of bank savings aims to achieve three key results: reducing financing costs; diversification of the customer base; consolidation of maturity of liabilities. The cross-border savings are supervised by the Croatian National Bank based on the reviews of the German supervisory body (BaFin).

3. Invoices-financial transactions

The Bank offers solutions that enable efficient, fast and secure transactions in managing funds.

3.1. Current accounts

Opening a current account offers a wide range of products and services tailored to the individual needs of each client:

- *Konto konekt* current account - current account package in three different models, depending on the range of additional services available to the client;
- allowed overdraft;
- cheques;
- standing order;
- Maestro debit card;
- *ko-net* on-line banking;
- SMS service.

In 2017, the Bank launched a product for mobile Android and iOS mobile phones called *mKovanica*, based on the *oTmBanking*(on-the-move Banking) application developed by ABBA/Mbanq. In 2018, the Bank will renew its graphic design image and complement the functionalities of *Ko-net* on-line Banking.

3.2. Giro accounts - citizens

Giro account holders can use the *ko-net* internet banking services, which offers them the most convenient means of managing the funds in the account.

4. Credit card operations

The Bank offers the following credit cards:

- Maestro debit card - the technology used in developing this chip card guarantees the improvement of the Bank's services as well as providing additional services related to the Maestro debit card;
- MasterCard charge;
- MasterCard revolving;
- Business master card.

In 2018, the Bank will complete the implementation of the *3D secure* security protocol offered by EGCP, in accordance with the technical parameters established by Mastercard SecureCode and in accordance with the IT requirements under the PSD2 Directive.

5. ATM machines

The Maestro debit card allows cash withdrawals on ATMs and payments via POS devices in the Republic of Croatia and cash withdrawal ATM (Cirrus) and POS payments (Maestro) abroad. On the Bank's and the MBNET network's ATMs, cash can be withdrawn without paying a fee (pre-defined number of free monthly operations). In 2017, the Bank finalised the process of connecting on-line with the card processor (EGCP) for managing authorisation processes, transaction and balance verifications, also in order to prevent operational risks.

Main risks and uncertainties faced by the Bank

The Bank's operating activities are exposed to various types of risks, which should be managed systematically. Risk management involves the identification, analysis, assessment, control and risk monitoring as prescribed by policies and procedures and by setting the limits for risk levels that are acceptable to the Bank.

The most significant types of risk to which the Bank is exposed are credit risk, liquidity risk, market risk (including interest rate risk, foreign currency risk and price risk) and operational risk.

For a more detailed analytical financial risk report, please refer to Notes 30), 31) and 32) of the accompanying audited annual financial statements as at 31 December 2017.

Operational risk

Operational risk is the risk of loss due to inadequate or unsuccessful internal processes, people and systems or external events, including compliance risk. Operational risk is inherent in all the Bank's activities, processes, products and systems.

The capital requirement for operational risk is calculated using the Basic Indicator Approach (BIA).

The Bank adopted the Operational Risk Management Policy and Guidelines for the Classification of Operational Risk using the mapping method. The significant risk threshold has been defined and, in case of such an event, a detailed analysis of the causes and consequences of the event is performed. All with a view to prevent the reappearance of such an event or to mitigate its consequences.

Significant events in progress and future activities

From the beginning of 2014, the new Management Board started the restructuring process and started developing the Bank's operating activities with the return of operating profit in 2014 and net profit in 2015, with all quality indicators of the credit portfolios in significant progress and converging towards the average values of the domestic banking system despite a poor loan portfolio inherited at the beginning of the term of office, thus confirming the prudent loan policy adopted by the new Management Board. In 2017, the Management Board revised the Business Plan for the period 2017-2020 (stand-alone) in order to reflect the more conservative economic assumptions, adhering to the supervisor's recommendation as well as the strategic guidelines of the majority owner to limit the risk of execution of the Plan within the regulatory framework marked by significant and growing compliance costs, especially charged to small banks. The plan foresees a special additional focus of operating activities on lending in the sector of citizens (consumer loans) with the share of loans in the sector of citizens of over 85% of the total portfolio with a reduced volume and margin dynamics due to increased competitiveness in consumer lending and payment services, with an average predictive ROE of over 10%.

As described above, FY 2017 was affected by an extraordinary value adjustment of HRK 11.88 million to cover potential losses and total expenses related to a multi-year civil court dispute. The responsibility for this matter is held by the President of the Management Board who was in office at the time of initiating the legal dispute (FY 2009), to which the notes to the financial statements audited by external auditing companies have been referring since 2011. If we exclude, as a precaution, the effect of this extraordinary value adjustment regarding this dispute, which is under review, the net operating result would amount to HRK 17.18 million, well above the 2017 Business Plan, with a profitability indicator at the top of the European banking sector (pro-forma ROE: 15.4%), which is the peak of the Bank's restructuring process initiated by the Management Board in office since 2014. An exceptional improvement in the profitability and operational risk profile of the Bank, albeit in a context marked by especially low interest rates and significant and growing legislative pressures (PSD2,

IFRS 9, GDPR, Basel IV, etc.) as well as competition, especially with respect to the so-called less significant credit institutions, was also recognised in the area of periodic operational risk assessment (SREP), along with reduced additional capital requirements for the Bank of 50 percentage points, i.e. the capital adequacy ratio reduced to 14.6% for FY 2018.

Hence, the Bank is strengthening its position in the segment of operations with citizens in order to become the Bank of choice for families and small and medium-sized enterprises, basing their own competitive advantage on "listening" as the real differentiating factor. Priority is reflected in developing the capability of generating revenue and in the capability of internally generating capital based on a strong balance sheet. The change of the banking information system plays a key role in implementing the offer of digital banking. The Bank's Business Plan is primarily a margin plan, and only then a plan of values: growth targets are necessarily conditioned by complying with capital requirements and the lending dynamics intends to preserve the capital buffer (CRR/CRD IV) and the own resources add-on (SREP). The Guidelines of the revised Bank's Business Plan continue to represent ambitious but achievable goals within the framework of the core scenario. The main risks to which the Bank remains exposed are:

- ❖ there is still a downside risk after the finalisation of the extraordinary administration or another procedure over the largest group of systemic importance in the Republic of Croatia;
- ❖ a high rate of non-fulfilment of counterparties' obligations, particularly in the segment of entrepreneurship, due to inefficiency and delays in court proceedings regarding collection;
- ❖ growing competitive dynamics in the context of banking consolidation, technological innovation and changes in client preferences;
- ❖ continuous adoption of new regulations and changes in national and international legislation, with high strategic alignment and significant strategic, operational and reputational risks.

Statement of the Management Board

Responsible Bank management represents the basis of the Bank's identity and is considered to be the most important condition for generating long-term value for all shareholders, clients and employees. The Bank does not have its own corporate governance code but refers to the code of the Croatian Banking Association.

The Bank's Management Board states that the Bank has established an organisational structure that is suitable for operations, while respecting applicable regulations in force in the Republic of Croatia and in accordance with the needs of modern banking activities. The Management Board continues to be committed to strengthening the principles of corporate culture to encourage a meritocratic, result-oriented organisational environment.

The Management Board and Supervisory Board cooperate through transparent communication and at regular meetings where the Management Board submits all necessary reports on the Bank's position and business operations, while the Supervisory Board provides the necessary support for the conduct of the business.

Corporate governance

The Bank's shareholders exercise their rights at the General Assembly, with the right to participate held by shareholders registered at the Central Depository Agency on the day as determined by the invitation to the General Assembly.

Each share entitles to one vote at the General Assembly, the right to dividend payment and other rights set forth by the law and the Bank's Articles of Association.

General Assembly of the Bank

The Management Board convenes the General Assembly at least once a year, by announcing an invitation to all shareholders in the Official Gazette, the Bank's bulletin, or by inviting each shareholder via registered mail. Apart from being convened regularly in the first eight months of the financial year, the Management Board or the Supervisory Board convenes the General Assembly whenever the Bank's

interests so require, or when there is a need for changes in business operations that require the decisions of the General Assembly.

The regular General Assembly meeting is usually held in the first six months of the financial year and is convened by the Management Board once the Supervisory Board examines the annual financial statements and business reports. The regular General Assembly acknowledges the annual financial statements as well as the annual report of the Management Board on the Bank's position accordingly making decisions on dismissing members of the Supervisory Board and the Management Board. The General Assembly decides on matters specifically defined by the law and the Bank's Articles of Association, and in particular on the election and dismissal of the members of the Supervisory Board, the appointment of an auditing company, share capital increase and decrease and other status changes.

The General Assembly decides on the principle of ordinary majority if, for individual decisions, the law or the Bank's Articles of Association do not specify otherwise.

Supervisory Board

For the benefit of the Bank, its successful operation and development, the cooperation between the Supervisory Board and the Management Board is continuous and effective. In this regard, the Management Board makes strategic decisions with the approval of the Supervisory Board.

Pursuant to the provisions of the Law, the Articles of Association and the Rules of Procedure of the Supervisory Board, decisions have been reached that can be adopted only with the approval of the Supervisory Board, such as: change of organisational structure, approval of large exposures, appointment of an auditing company, acquisition and disposal of real estate, opening and closing branch offices, entering interest groups, determining the annual plan and budget.

An important element of effective cooperation between the two bodies is constant communication, both through comprehensive and detailed reports, as well as through informal communication.

As at 31 December 2017, the Supervisory Board consists of five members, one of whom is the president and the other the vice president of the Supervisory Board. Members of the Supervisory Board are elected by the General Assembly. In accordance with applicable regulations, one member of the Supervisory Board must be independent.

The Supervisory Board oversees the management of the Bank's operations, appoints and dismisses the members of the Bank's Management, directs the Bank's business policy and actively contributes to its realisation. Members of the Supervisory Board receive remuneration for their work in accordance with the decision of the General Assembly of the Bank.

Avoiding conflicts of interest in the work of the Bank's Supervisory Board

All members of the Supervisory Board must represent the Bank's best interests and well-being: for the purpose of avoiding conflict of interest in the work of the Supervisory Board, the rules applicable to Management Board members apply.

Risk and Audit Committee

The Supervisory Board has established a Risk and Audit Committee with a view to thoroughly monitoring the Bank's activities. The Risk and Audit Committee, whose duties are set out in the Audit Act and the Credit Institutions Act, deals with issues in accordance with applicable regulations, in particular regarding issues related to financial statements, processes and effectiveness of the internal audit and the internal control system, risks, overseeing the audit of financial statements and the work of independent auditors.

Management Board of the Bank

The Management Board of the Bank consists of two members, one of which is the president who manages the work of the Management Board, coordinates all business functions and reports to the Supervisory Board and the General Assembly on behalf of the Management Board.

The Bank's Management Board manages the Bank's operations at its own risk and represents the Bank in such a way that the President of the Management Board represents the Bank solely and independently, whereas a Member of the Management Board represents the Bank jointly with the President of the Management Board, simultaneously adhering to the limits set forth in the provisions of the Articles of Association, the decisions of the Supervisory Board and the General Assembly and the Rules of Procedure of the Management Board.

In conducting business, the Bank's Management Board ensures that the Bank operates in accordance with all applicable regulations and rules of the profession, in particular with regard to monitoring all risks to which it is exposed, monitoring and achieving an adequate level of capital in relation to the necessary capital requirements. The Management Board guarantees the correct preparation of financial statements in accordance with accounting policies and standards of Croatian laws and regulations of the Croatian National Bank.

Avoiding conflicts of interest in the work of the Bank's Management Board

By complying with applicable regulations and internal rules, the Bank's Management ensures that the issue of conflict of interest is regulated in a transparent and functional manner. In this respect, the members of the Management Board adhere to applicable regulations and internal acts regulating their relationship with the Bank at all levels.

In managing the Bank's operations, members of the Management Board are not allowed to make and implement decisions that are contrary to or in conflict with the Bank's interests, including the use of confidential data for the purpose of achieving personal gain. The Management Board of the Bank is supported by the following committees: The Assets and Liabilities Committee, the Loan Committee and the Asset Quality Assurance Committee.

Internal control system

In order to protect the Bank's assets and the entire business operations, a system of internal controls has been established in accordance with applicable regulations. The

internal control system should be further improved in a way to ensure maximum operating efficiency, financial reporting reliability and consistent compliance with laws and by-laws and good business practices, primarily in order to manage loan and operational risk on a market characterised by a large number of doubtful receivables and reduced efficiency of the judiciary, all in order to reduce legal disputes and the duration of proceedings.

In carrying out these controls all organisational parts of the Bank participate directly or indirectly, together with the members of the Management Board and the Supervisory Board.

Transparent and timely reporting

The Bank is especially concerned with the timely and complete communication with the Croatian National Bank, which is realised through periodic reports and the delivery of other important documentation and information.

Management Board of Banka Kovanica d.d.

President of the Management Board

Member of the Management Board

Nicola Ceccaroli

Ivan Mužić

Varaždin, 16 March 2018

**Financial statements as at
31 December 2017**

Responsibility for the financial statements

Pursuant to the Croatian Accounting Act (Official Gazette 78/15, 134/15 and 120/16), the Management Board is responsible for ensuring that the financial statements are prepared for each financial year in accordance with statutory accounting regulations applicable to banks in Croatia, in order to give a true and fair view of the financial position and results of the Bank for that period.

The Management Board has a reasonable expectation that the Bank has adequate resources to continue in operational existence for the foreseeable future. For this reason, the Management Board continues to adopt the going concern basis in preparing financial statements.

In preparing the financial statements, the responsibilities of the Management Board include ensuring that:

- suitable accounting policies are selected and then applied consistently;
- judgements and estimates are reasonable and prudent;
- applicable accounting standards are followed, subject to any material departures disclosed and explained in the financial statements; and
- the financial statements are prepared on the going concern basis unless it is inappropriate to presume that the Bank will continue in business.

The Management Board is responsible for keeping proper accounting records, which disclose with reasonable accuracy at any time the financial position of the Bank and must also ensure that the financial statements comply with the Croatian Accounting Act (Official Gazette 78/15, 134/15 and 120/16). The Management Board is also responsible for safeguarding the assets of the Bank and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Signed on behalf of the Management Board:

Nicola Ceccaroli

President of the Management Board

Ivan Mužić

Member of the Management Board

Banka Kovanica d.d.,
P. Preradovića 29
Varaždin

16 March 2018



Independent Auditor's Report

To the Shareholders and Management Board of Banka Kovanica d.d.:

Report on audit of financial statements

Our opinion

In our opinion, the financial statements give true and fair view of the financial position of Banka Kovanica d.d. (the "Bank") as at 31 December 2017, and of its financial performance and its cash flows for the year then ended in accordance with statutory accounting regulations for banks in Republic of Croatia.

Our opinion is consistent with our additional report to the Supervisory Board.

What we have audited

The Bank's financial statements comprise:

- the statement of comprehensive income for the year ended on 31 December 2017
 - the statement of financial position as at 31 December 2017;
 - the statement of changes in equity for the year then ended;
 - the statement of cash flows for the year then ended; and
 - the notes to the financial statements, which include a summary of significant accounting policies.
-

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Independence

We are independent of the Bank in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code). We have fulfilled our other ethical responsibilities in accordance with the IESBA Code.

To the best of our knowledge and belief, we declare that we have not provided non-audit services that are prohibited under Article 5(1) of Regulation (EU) No 537/2014, and furthermore, we have not provided other permissible non-audit services to the Bank in the period from 1 January 2017 through 31 December 2017.

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Commercial Court in Zagreb, no. Tt-99/7257-2, Reg. No.: 080238978; Company ID No.: 81744835353; Founding capital: HRK 1,810,000.00, paid in full; Management Board: J. M. Gasparac, President; S. Dusic, Member; T. Macasovic, Member; Banking account: Raiffeisenbank Austria d.d., Petrinjska 59, Zagreb, Croatia, IBAN: HR8124840081105514875.



Our audit approach

Overview

Materiality	<ul style="list-style-type: none">Overall materiality for financial statements as a whole: HRK (Croatian kuna) 1,6 million, which represents 10% of average income before tax from continued operations for the last 5 years.
Key audit matters	<ul style="list-style-type: none">Impairment of loans and advances to customers

How we tailored our audit scope

We designed our audit by determining materiality and assessing the risks of material misstatement in the financial statements. In particular, we considered where management made subjective judgements; for example, in respect of significant accounting estimates that involved making assumptions and considering future events that are inherently uncertain. We also addressed the risk of management override of internal controls, including among other matters consideration of whether there was evidence of bias that represented a risk of material misstatement due to fraud.

We tailored the scope of our audit in order to perform sufficient work to enable us to provide an opinion on the financial statements as a whole, taking into account the structure of the Bank, the accounting processes and controls, and the industry in which the Bank operates.

Materiality

The scope of our audit was influenced by our application of materiality. An audit is designed to obtain reasonable assurance whether the financial statements are free from material misstatement. Misstatements may arise due to fraud or error. They are considered material if individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

Based on our professional judgement, we determined certain quantitative thresholds for materiality, including the overall materiality for the financial statements as a whole as set out in the table below. These, together with qualitative considerations, helped us to determine the scope of our audit and the nature, timing and extent of our audit procedures and to evaluate the effect of misstatements, if any, both individually and in aggregate on the financial statements as a whole.

<i>Overall materiality for financial statements as a whole</i>	HRK 1,6 million
<i>How we determined it</i>	10% of average income before tax from continued operations for the last 5 years
<i>Rationale for the materiality benchmark applied</i>	We have used average income before tax from continued operations as the benchmark due to significant fluctuations of profit (loss) before tax in previous years. We have used income before tax from continued operations because, based on our judgement, it represents benchmark which is commonly used to indicate the success of the Bank's operations.



Key audit matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Key audit matter	How our audit addressed the Key audit matter
<p><i>Impairment of loans and advances to customers</i></p> <p><i>See note 16 to the financial statements under heading Loans and advances to customers in the amount of HRK 809,998 thousand, note 2.3 under heading Critical accounting judgements and key sources of estimation uncertainty and notes 8 and 31 for further information</i></p> <p>Impairment allowances are the management's best estimate of incurred losses of loans and advances portfolio at the reporting date.</p> <p>Impairment allowances for loans and advances losses are recognized if there is objective evidence that the Bank will not be able to collect all amounts due.</p> <p>The amount of the allowance is determined in accordance with accounting regulations applicable to banks in Croatia as explained in note 2.1. It is generally determined as the difference between book value and recoverable value, which represents the present value of expected cash flows, including amounts recoverable from guarantees and collateral, discounted at the original effective interest rate for a loan.</p>	<p>We tested controls for approving and monitoring of loans and advances to customers, including appropriateness of classification of performing and non-performing loans, calculation of days past due and calculation of impairment allowances.</p> <p>We have selected a sample of loans and advances to customers with focus on exposures with potentially highest impact on the financial statements due to their size or risk profile. We have also focused on other exposures we independently assessed as highly risky, such as restructured exposures and non-performing loans with low coverage of impairment allowances.</p> <p>We have reviewed supporting documentation for selected exposures and discussed any issues with responsible persons. For impaired exposures, we have re-examined key assumptions used in future cash flows estimates, such as value of collateral to ensure the exposures have been classified and measured in accordance with accounting regulations applicable to banks in Croatia.</p> <p>We found no material issues arising from our work.</p>

Reporting on other information including the Management report

Management is responsible for the other information. The other information comprises the Annual Report of the Bank, which includes the Management Report, but does not include the financial statements and our independent auditor's report thereon.

Our opinion on the financial statements does not cover the other information, including the Management Report.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated.

With respect to the Management Report, we also performed procedures required by the Accounting Act in Croatia. Those procedures include considering whether the Management Report includes the disclosures required by Article 21 of the Accounting Act.

Based on the work undertaken in the course of our audit, in our opinion:

- the information given in the Management Report for the financial year for which the financial statements are prepared is consistent, in all material respects, with the financial statements; and
- the Management Report has been prepared in accordance with the requirements of Article 21 of the Accounting Act.

In addition, in light of the knowledge and understanding of the Bank and its environment obtained in the course of the audit, we are also required to report if we have identified material misstatements in the Management Report. We have nothing to report in this respect.

Responsibilities of management and those charged with governance for the financial statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards as adopted in the European Union, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Bank's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Bank or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Bank's financial reporting process.

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an independent auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Bank's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our independent auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our independent auditor's report. However, future events or conditions may cause the Bank to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our independent auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.



Report on other legal and regulatory requirements

Appointment

We were first appointed as auditors of the Bank on 27 June 2014. Our engagement appointment for 2017 is our first year as the auditors of the Bank.

The certified auditor engaged as partner on the audit resulting in this independent auditor's report is Siniša Dušić.

PricewaterhouseCoopers d.o.o.
Heinzlova 70, Zagreb
19 March 2018

This version of our report is a translation from the original, which was prepared in Croatian language. All possible care has been taken to ensure that the translation is an accurate representation of the original. However, in all matters of interpretation of information, views or opinions, the original language version of our report takes precedence over this translation.

Statement of comprehensive income

for the period from 1 January to 31 December 2017

	Note	2017 HRK'000	2016 HRK'000
Interest income		74,920	76,965
Interest expense		(15,955)	(23,699)
Net interest income	4	58,965	53,266
Fee and commission income		7,589	6,667
Fee and commission expense		(2,402)	(2,121)
Net fee and commission income	5	5,187	4,546
Foreign exchange differences – net	6	640	1,532
Result of assets available for sale – net	17	4	469
Other operating income	7	1,594	4,331
Impairment charge for credit losses – net	8	(13,631)	(17,188)
Administration costs	9	(30,703)	(40,062)
Other operating expenses	10	(16,749)	(6,462)
Profit/loss before income tax		5,307	432
Income tax	11	-	-
Profit/loss after tax		5,307	432
Unrealised (loss)/gains from available-for-sale financial assets		66	216
Other comprehensive loss/(profit)		66	216
Total comprehensive income/loss		5,373	648
Earnings/(loss) per share	12	1.5	0.13

The notes to the financial statements are an integral part of the Statement of comprehensive income.

Statement of financial position

as at 31 December 2017

	Note	31 December 2017 HRK'000	31 December 2016 HRK'000
ASSETS			
Cash on hand and balances with banks	13	154,031	163,635
Obligatory reserve with the Croatian National Bank	14	63,838	69,099
Placements with banks	15	1,018	1,024
Loans and advances to customers	16	809,998	814,889
Available-for-sale financial assets	17	43,616	78,232
Property and equipment	19	14,909	15,477
Intangible assets	19	2,347	2,538
Reposessed collateral	20	32,933	37,301
Other assets	21	22,400	18,515
Total assets		1,145,090	1,200,711
LIABILITIES			
Deposits from customers	22	948,364	1,013,915
Due to banks	23	8,661	23,469
Hybrid instruments	24	39,881	39,857
Other liabilities	26	31,233	11,892
		1,028,139	1,089,133
SHAREHOLDERS' EQUITY			
Share capital	27	106,962	103,943
Treasury shares		(15)	(38)
Share premium		(23)	652
Reserves		4,720	4,655
Retained earnings		-	1,933
Profit for the year		5,307	432
		116,951	111,577
Total liabilities and shareholders' equity		1,145,090	1,200,710

The notes to the financial statements are an integral part of the Statement of financial position.

Statement of changes in equity

for the year from 1 January to 31 December 2017

	Share capital	Treasury shares	Capital reserves	Other reserves	Fair value reserves	Retained earnings/ (accumulated loss)	Total
	HRK'000	HRK'000	HRK'000	HRK'000	HRK'000	HRK'000	HRK'000
Balance at 31 December 2015	333,834	(38)	76,453	1,490	(569)	(300,229)	110,941
Coverage of accumulated losses	(233,032)	-	(76,453)	(1,490)	-	310,976	-
Transfer to reserves	(652)	-	652	5,008	-	(5,008)	-
Dividends paid	-	-	-	-	-	(3,806)	(3,806)
Contributions in equity	3,793	-	-	-	-	-	3,793
Profit for the year	-	-	-	-	-	432	432
Unrealised gains on available-for- sale financial assets	-	-	-	-	216	-	216
Total comprehensive income/(loss)	-	-	-	-	216	432	648
Balance at 31 December 2016	103,943	(38)	652	5,008	(353)	2,365	111,577
Coverage of accumulated losses	-	-	-	-	-	-	-
Transfer to reserves	-	-	-	-	-	-	-
Dividends paid	-	-	(652)	-	-	(2,364)	(3,016)
Contributions in equity	3,018	-	-	-	-	-	3,018
Profit for the year	-	-	-	-	-	5,307	5,307
Unrealised gains on available-for- sale financial assets	-	-	-	-	66	-	66
Total comprehensive income/(loss)	-	-	-	-	66	5,307	5,373
Balance at 31 December 2017	106,961	(38)	-	5,008	(287)	5,307	116,951

The notes to the financial statements are an integral part of the Statement of changes in equity.

Statement of cash flows

for the year from 1 January to 31 December 2017

	Note	2017 HRK'000	2016 HRK'000
Cash flow from operating activities			
Profit for the year		5,307	432
Depreciation and amortisation	9, 19	1,556	1,877
Write-off and disposals of property and equipment	19	183	37
Impairment charge for credit losses – net	8	13,630	17,189
Result of assets available for sale – net		726	(355)
Other non-cash items		4,368	783
Operating result before changes in operating assets		25,770	19,963
(Increase)/decrease in assets with the Croatian National Bank		5,261	12,827
(Increase)/decrease in loans and advances to customers		(7,679)	(50,166)
(Increase)/decrease in repossessed and other assets		(4,940)	9,641
Increase/(decrease) in deposits from customers		(65,551)	13,350
Increase/(decrease) in hybrid instruments		24	5,263
Increase/(decrease) in other liabilities		19,341	(7,818)
Net cash used in operating activities		(27,774)	3,059
Cash flow from investing activities			
Purchase of property and equipment and intangible assets	19	(979)	(2,196)
Purchase of available-for-sale financial assets	17	(33,876)	(93,267)
Disposal of available-for-sale financial assets	17	67,832	80,752
Net cash outflow from investing activities		32,977	(14,711)
Cash flow from financing activities			
Contributions in equity	27	3,018	3,793
Dividends paid		(3,016)	(3,806)
Increase/(decrease) of deposits from banks		(7,041)	6,269
Increase/(decrease) in bank borrowings		(7,767)	(4,875)
Net cash from financing activities		(14,806)	1,381
Net (decrease)/increase in cash and cash equivalents		(9,603)	(10,271)
Cash and cash equivalents at beginning of year		163,633	173,906
Cash and cash equivalents at end of year	28	154,031	163,635

The notes to the financial statements are an integral part of the Statement of cash flows.

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

1. General information

Activities

BANKA KOVANICA d.d. Varaždin (the Bank) was incorporated in 1997 and registered at the Commercial Court in Varaždin. The address of the Bank's registered office is in Varaždin, P. Preradovića 29.

The Bank's registered activities are as follows:

- accepting cash deposits
- granting loans and other placements in its own name and for its own account
- issuing electronic money
- issuing guarantees and other warranties
- factoring
- finance lease (leasing)
- credit operations, including consumer credit, mortgage loans and financing of commercial operations (including forfeiting)
- trading in its own name and for its own account or in its own name and for a customer's account: in money market instruments and other transferable securities, foreign currencies including foreign exchange activities
- trading in financial forward contracts and options, currency and interest instruments
- performing local and international payments
- collection of data, conducting analyses and providing information on the creditworthiness of legal and natural persons who conduct business activities on their own
- representation in the sale of insurance policies, in accordance with the law regulating insurance, intermediation and representation in insurance activities
- issuing and managing instruments of payment, intermediation in concluding financial deals.

Supervisory Board

Emanuele Restelli Prandoni Della Fratta	President
Ivan Majdak	Vice president
Pietro Giacomini	Member
Albani Marino	Member
Mladen Vedriš	Member

Management Board

Nicola Ceccaroli	President
Ivan Mužić	Member

The Bank is subject to the regulatory requirements of the Croatian National Bank. These regulations include limits and other restrictions pertaining to minimum capital adequacy requirements, classification of loans and off-balance sheet commitments and provisioning to cover credit risk, liquidity, interest rate and foreign currency positions.

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

2. Basis of presentation of financial statements

The principal accounting policies applied in the preparation of these financial statements are summarised below. Where specific accounting policies are aligned with the accounting principles set out in International Financial Reporting Standards (IFRS), reference may be made to certain Standards in describing the accounting policies of the Bank; unless otherwise stated, these references are to Standards applicable in the European Union as at 31 December 2016.

2.1. Compliance with Croatian bank accounting requirements and IFRS

The financial statements have been prepared in accordance with statutory accounting requirements for banks in Croatia. The Bank's operations are subject to the Credit Institutions Act, in accordance with which the Bank's financial reporting is regulated by the Croatian National Bank (the CNB) which is the central monitoring institution of the banking system in Croatia. These financial statements have been prepared in accordance with these banking regulations.

The main difference between the requirements of the International Financial Reporting Standards (IFRS) and of CNB relates to the provisions for impairment losses of financial assets calculated on a portfolio basis. In accordance with CNB regulations, banks domiciled in Croatia should recognise impairment on the portfolio basis by the prescribed rates on balance sheet and off-balance sheet exposure to credit risk of counterparties for which impairment on individual basis is not determined, while IFRS requires that the provisions on the portfolio basis should be determined for existing but unidentified losses on the basis of valuation models taking into account individual characteristics of the Bank and the counterparty in the portfolio (e.g. collateral, customers' scoring, etc.).

The Bank calculates impairment losses on corporate lending as the present value of expected future cash flows, discounted at the instrument's original effective interest rate, in accordance with IFRS. CNB requires the amortisation of the calculated discount to be presented in the income statement within the movement in impairment losses on loans and advances to customers and other assets, rather than as interest income, as required by International Financial Reporting Standards.

Additionally, CNB prescribes the minimum levels of impairment losses against certain specifically identified impaired exposures, which may be different from the impairment loss required to be recognised in accordance with IFRS.

2.2. Basis of preparation

The financial statements are presented in thousands of Croatian kuna (HRK), unless otherwise stated.

The financial statements have been prepared on the accrual basis of accounting, under the going concern assumption.

The financial statements are prepared on the historical or amortised cost basis, except for available-for-sale financial assets, which are recorded at fair value. Other financial assets and liabilities, and non-monetary assets and liabilities, are stated at amortised or historical cost, less impairment, where appropriate.

The accounting policies adopted are consistent with those of the previous financial year unless otherwise stated and disclosed.

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

Standards and interpretations issued and effective:

The Bank has adopted the following new and amended standards for its annual reporting period commencing 1 January 2017 which were endorsed by the European Union and which are relevant for the Company's financial statements:

- Recognition of Deferred Tax Assets for Unrealised Losses - Amendments to IAS 12
- Disclosure Initiative - Amendments to IAS 7

The adoption of these improvements did not have any impact on the current period or any prior period and is not likely to affect future periods.

New standards and interpretations issued but not yet effective

Certain new standards and interpretations have been published that are not mandatory for 31 December 2017 reporting periods and have not been early adopted by the Bank. The Bank's assessment of the impact of these new standards and interpretations is set out below:

- *IFRS 9 Financial instruments and associated amendments to various other standards (effective for annual periods beginning on or after 1 January 2018)*

The complete version of IFRS 9 replaces most of the guidance in IAS 39. IFRS 9 retains but simplifies the mixed measurement model and establishes three primary measurement categories for financial assets: amortised cost, fair value through OCI and fair value through P&L. The basis of classification depends on the entity's business model and the contractual cash flow characteristics of the financial asset. Investments in equity instruments are required to be measured at fair value through profit or loss with the irrevocable option at inception to present changes in fair value in OCI. There is now a new expected credit losses model that replaces the incurred loss impairment model used in IAS 39. For financial liabilities, there were no changes to classification and measurement except for the recognition of changes in own credit risk in other comprehensive income, for liabilities designated at fair value through profit or loss. IFRS 9 relaxes the requirements for hedge effectiveness by replacing the bright line hedge effectiveness tests. It requires an economic relationship between the hedged item and hedging instrument and for the 'hedged ratio' to be the same as the one the Management Board actually uses for risk management purposes.

The new standard also introduces expanded disclosure requirements and changes in presentation. These are expected to change the nature and extent of Bank's disclosures of its financial instruments, particularly in the year of the adoption of this standard.

This standard must be applied for financial years commencing on or after 1 January 2018. The Bank will apply the new rules from 1 January 2018, with the practical expedients permitted under the standard. Comparatives for 2017 shall not be restated.

Classification of financial assets under IFRS 9

IFRS 9 applies one classification approach for all types of financial assets, using two criteria to determine how financial assets are classified and measured:

1. Business model for managing financial assets
2. Contractual cash flow characteristics of financial assets

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

Business models for managing financial assets include:

- hold-to-collect business model whose objective is to hold the assets for the purpose of collecting contractual cash flows
- hold-to-collect and sell business model whose objective is met both by collecting the contractual cash flows and selling the financial assets
- other business models.

Financial assets are classified into the following categories:

- at their amortised cost (AC),
- at fair value through other comprehensive income (FVTOCI),
- at fair value through profit or loss (FVTPL),

The Bank shall classify the following assets under financial assets classified at amortised cost (AC):

1. Deposits with the CNB and banking institutions

2 Held-to-maturity debt securities

3. Loans and receivables

The Bank has estimated the effects of the initial application of IFRS 9 on financial assets carried at amortised cost and expects an increase of HRK 9.8 million in impairment (net increase in provisions as at 1 January 2018).

The Bank will classify the assets it manages in order to realise cash flows by collecting contracted cash flows and selling assets as financial assets classified at fair value through other comprehensive income (FVTOCI). The Bank classified available-for-sale debt securities into that category, and these are securities of the Republic of Croatia and foreign government bonds.

The Bank has estimated the effects of the initial application of IFRS 9 on financial assets carried at fair value through other comprehensive income and expects a decrease in retained earnings in the total amount of HRK 106 thousand as at 1 January 2018.

The Bank will classify financial assets that are currently classified as available-for-sale financial assets at fair value through profit or loss. The estimated impact of the classification is reflected in the reclassification of the unrealised loss of HRK 432 thousand from the position of the revaluation reserve in equity to a decrease in retained earnings (recorded as at 1 January 2018).

- *IFRS 15 Revenue from contracts with customers and associated amendments to various other standards (effective for annual periods beginning on or after 1 January 2018)*

The IASB has issued a new standard for the recognition of revenue. This will replace IAS 18 which covers contracts for goods and services and IAS 11 which covers construction contracts.

The new standard is based on the principle that revenue is recognised when control of a good or service transfers to a customer – so the notion of control replaces the existing notion of risks and rewards.

Key changes to current practice are:

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

- Any bundled goods or services that are distinct must be separately recognised, and any discounts or rebates on the contract price must generally be allocated to the separate elements.
- Revenue may be recognised earlier than under current standards if the consideration varies for any reasons (such as for incentives, rebates, performance fees, royalties, success of an outcome, etc.)
- The point at which revenue is able to be recognised may shift: some revenue which is currently recognised at a point in time at the end of a contract may have to be recognised over the contract term and vice versa.
- There are new specific rules on licenses, warranties, non-refundable upfront fees and, consignment arrangements, to name a few; and
- As with any new standard, there are also increased disclosures.

Entities will have a choice of full retrospective application, or prospective application with additional disclosures. The Bank is currently assessing the impact of the amendments on its financial statements, but does not expect any significant impact. The Bank plans to adopt this amendment on its effective date.

- *IFRS 16 Leases (issued in January 2016 and effective for annual periods beginning on or after 1 January 2019)*

IFRS 16 will affect primarily lessee accounting and will result in the recognition of almost all leases on the balance sheet. The standard removes the current distinction between operating and financing leases and requires recognition of an asset (the right to use the leased item) and a financial liability to pay rentals for virtually all lease contracts. An optional exemption exists for short-term and low-value leases.

The income statement will also be affected because the total expense is typically higher in the earlier years of a lease and lower in later years. Additionally, operating expense will be replaced with interest and depreciation, so key metrics like EBITDA will change.

Operating cash flows will be higher as cash payments for the principal portion of the lease liability are classified within financing activities. Only the part of the payments that reflects interest can continue to be presented as operating cash flows.

Lessor accounting will not change significantly. Some differences may arise as a result of the new guidance on the definition of a lease. Under IFRS 16, a contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

The standard will affect primarily the accounting for the Bank's operating leases. At the reporting date, the Bank has minimum future payments for non-performing leases in the amount of approximately HRK 9.567 thousand. At this stage, the Bank is not able to estimate the impact of the new standard on the Bank's financial statements, it will make more detailed assessments of the impact over the next twelve months. The Bank plans to adopt this standard on its effective date. The Bank intends to apply the simplified transition approach and will not restate comparative amounts for the year prior to first adoption.

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

2.3. Critical accounting judgements and key sources of estimation uncertainty

In the application of the Bank's accounting policies, the Management Board is required to make judgements, estimates and assumptions about the carrying amounts of assets and liabilities that are not readily apparent from other sources. The estimates and associated assumptions are based on historical experience and other factors that are considered to be relevant. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period or in the period of the revision and future periods if the revision affects both current and future periods.

The key assumptions concerning the future, and other key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year, are discussed below.

While it is possible that in particular periods the Bank may sustain losses, which are substantially relative to the allowance for impairment losses, it is the judgement of the Management Board that the allowance for impairment losses is adequate to absorb losses incurred on the risk assets.

There are several legal actions against the Bank, which have arisen from the regular course of its operations. The Bank's Management Board believes that the probable outcome will have no significant negative effects on the Banks' financial position or its future operating results.

3. Summary of significant accounting policies

The principal accounting policies adopted in the preparation of these financial statements are set out below. These accounting policies have been consistently applied to all the years presented, unless otherwise stated.

3.1. Interest income and expense

Interest income is accrued on a time-basis, by reference to the principal outstanding and at the effective interest rate applicable, which is the rate that exactly discounts estimated future cash receipts through the expected life of the financial asset to that asset's net carrying amount.

Interest income includes coupons earned on fixed income investments and securities and accrued discount and premium on treasury bills and other discounted instruments.

When loans become impaired, they are written down to their recoverable amounts and interest income thereafter is recognized based on the rate of interest that was used to discount the future cash flows for the purpose of measuring the recoverable amount.

3.2. Fee and commission income and expense

Fees and commissions consist mainly of fees on domestic and foreign payments, fees for issuing guarantees and letters of credit, fees and commissions on card operations and other credit instruments issued by the Bank. Fees and commissions are generally recognized as income when service is provided. Loan origination

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

fees for loans which are probable of being drawn down are deferred (together with the related direct issue costs) and recognized as an adjustment to the effective yield of the loan, and thus adjust the interest income.

3.3. Taxation

The tax expense represents the sum of the tax currently payable and deferred tax. The current tax liability is based on taxable profit for the year. Taxable profit differs from profit as reported in the income statement because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible. The Bank's liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the balance sheet date.

Deferred tax is recognised on differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit, and is accounted for using the balance sheet liability method. Deferred tax liabilities are generally recognised for all taxable temporary differences, and deferred tax assets are generally recognised for all deductible temporary differences to the extent that it is probable that taxable profits will be available against which those deductible temporary differences can be utilised.

The carrying amount of deferred tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered. Deferred tax assets and liabilities are measured at the tax rates that are expected to apply in the period in which the liability is settled or the asset realised. Deferred tax is recognised as an expense or income in profit or loss, except when it relates to items credited or debited directly to equity, in which case the deferred tax is also recognised directly in equity. Deferred tax assets and liabilities are offset when they relate to income taxes levied by the same taxation authority and the Bank has the ability and intention to settle its current tax asset and liability on a net basis.

3.4. Segment reporting

A business segment is a group of assets and operations engaged in providing products or services that are subject to risks and returns that are different from those of other business segments. A geographical segment is engaged in providing products or services within a particular economic environment that are subject to risks and returns different from those of segments operating in other economic environments.

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

3.5. Foreign currency translation

(a) Functional and presentation currency

Items included in the financial statements of the Bank are measured using the currency of the primary economic environment in which the Bank operates (the functional currency). The Bank's financial statements are presented in Croatian kuna (HRK), which is the Bank's functional currency and presentation currency.

(b) Transactions and balances

Transactions denominated in foreign currencies are translated into HRK at the prevailing exchange rates on the date of the transaction. Monetary items denominated in foreign currencies are retranslated into HRK at the appropriate spot rates of exchange prevailing at the balance sheet date. Non-monetary items carried at fair value that are denominated in foreign currencies are retranslated at the rates prevailing on the date when the fair value was determined. Non-monetary items that are measured in terms of historical cost in a foreign currency are not retranslated.

Exchange differences arising on the settlement of monetary items, and on their retranslation, are included in 'Foreign exchange differences - net' for the period. Exchange differences arising on the retranslation of non-monetary assets carried at fair value are included in profit or loss for the period except for exchange differences arising on the retranslation of non-monetary assets available-for-sale in respect of which gains and losses are recognized directly in equity. For such non-monetary items, any exchange component of that gain or loss is also recognized directly in equity.

The Bank has assets and liabilities originated in HRK, which are linked to a foreign currency clause. Due to this clause the Bank has to revalue both the asset and related liability by higher of: foreign exchange rate valid as at the date of maturity, or foreign exchange rate valid as at the date of origination of the financial instrument. In case of liability linked to this clause, the counterparty has the same option. As such, the Bank values its assets and liabilities related to this clause by the middle exchange rate of CNB valid at the balance sheet date or by the exchange rate agreed by the option (rate valid at origination), whichever is higher.

The principal rates of exchange set forth by CNB and used in the preparation of the Bank's balance sheet at the reporting dates were as follows:

31 December 2017	EUR 1 = HRK 7.513648	USD 1 = HRK 6.269733
31 December 2016	EUR 1 = HRK 7.557787	USD 1 = HRK 7.168536

3.6. Cash and cash equivalents

For the purposes of the cash flow statement, cash and cash equivalents comprise cash on hand, balances with CNB, balances with banks on giro accounts and term deposits with other banks with remaining maturities of three months or less.

Cash and cash equivalents exclude the obligatory reserves with CNB as these funds are not available for the Bank's day to day operations. The obligatory reserve with CNB is a required reserve to be held by all commercial banks licensed in Croatia.

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

3.7. Financial assets

Financial assets held by the Bank are categorized into portfolios in accordance with the Bank's intent on acquisition and pursuant to the Bank's investment strategy. Financial assets and liabilities are classified as 'at fair value through profit or loss', 'held to maturity', 'available for sale' or as 'loans and receivables'. The principal difference among the portfolios relates to the measurement of financial assets and the recognition of their fair values in the financial statements.

All financial assets and liabilities are recognized and derecognized on a settlement date basis, where the purchase or sale of a financial asset or liability is under a contract whose terms require delivery of the financial asset within the timeframe established by the market concerned.

When a financial asset or financial liability is recognized initially, the Bank measures it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

(a) Financial assets at fair value through profit or loss

Financial assets are classified at fair value through profit or loss where the financial assets are held for trading.

A financial asset is classified as held for trading if:

- it has been acquired principally for the purpose of selling in the near future; or
- it is a part of an identified portfolio of financial instruments that the Bank manages and has a recent actual pattern of short-term profit-taking; or
- it is a derivative that is not designated and effective as a hedging instrument.

Measurement:

Financial assets at fair value through profit or loss are initially accounted at fair value and related transaction costs are recorded as an expense. Subsequent to the initial recognition, financial assets at fair value through profit or loss are accounted for and stated at fair value which approximates the price quoted on recognised stock exchanges or acceptable valuation models. The Bank includes unrealised gains and losses in 'Result of trading assets - net'. Interest earned on assets at fair value through profit or loss representing coupons on debt securities is accrued on a daily basis and reported as 'Interest income' in the income statement.

Dividends on trading securities are recorded when declared and included as a receivable in the balance sheet line 'Other assets' and in 'Other operating income' in the income statement.

All purchases and sales of securities held for trading that require delivery within the time frame established by regulation or market convention ('regular way' purchases and sales) are recognized as spot transactions. Transactions that do not meet the 'regular way' settlement criterion are treated as financial derivatives.

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

(b) Assets available for sale

Available-for-sale financial assets are those non-derivative financial assets that are designated as available for sale or are not classified as: (a) loans and receivables, (b) held-to-maturity investments or (c) financial assets at fair value through profit or loss.

This portfolio comprises equity and debt securities. Subsequent to initial recognition, available-for-sale financial assets are re-measured at fair value based on quoted prices or amounts derived from cash flow models.

In circumstances where quoted market prices are not readily available, the fair value of debt securities is estimated using the present value of future cash flows and the fair value of unquoted equity instruments is estimated using applicable price/earnings or price/cash flow ratios refined to reflect specific circumstances of the issuer.

For available-for-sale assets, gains and losses arising from changes in fair value are recognised directly in equity under the caption 'Reserves', until the security is disposed of or is determined to be impaired, at which time the cumulative gain or loss previously recognized in equity is included in the profit or loss for the period.

The Bank assesses at each balance sheet date whether there is objective evidence that a financial asset or a group of financial assets is impaired. In the case of equity investments classified as available for sale, a significant or prolonged decline in the fair value of the security below its cost is considered in determining whether the assets are impaired. If any such evidence exists for available-for-sale financial assets, the cumulative loss – measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that financial asset previously recognised in profit or loss – is removed from equity and recognised in the income statement.

Impairment losses recognized in profit or loss for equity investments classified as available-for-sale are not subsequently reversed through profit or loss. Impairment losses recognised in profit or loss for debt instruments classified as available-for-sale are subsequently reversed if an increase in the fair value of the instrument can be objectively related to an event occurring after the recognition of the impairment loss.

Interest earned whilst holding available-for-sale securities is accrued on a daily basis using the effective interest rate method and reported as "Interest income" in the income statement.

Foreign exchange differences related to available-for-sale equity instruments held in foreign currency are reported together with fair value gains and losses in equity until the financial asset is sold. Foreign exchange differences related to available-for-sale debt instruments held in foreign currency are reported in the income statement.

Dividends on securities available for sale are recorded as declared and included as a receivable in the balance sheet line 'Other assets' and in 'Other operating income' in the income statement. Upon payment of the dividend, the receivable is offset against the collected cash.

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

(c) Held-to-maturity investments

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity that the Bank's Management Board has the positive intention and ability to hold to maturity. Held-to-maturity investments are carried at amortised cost using the effective interest method, less any allowance for impairment.

The Bank assess on a regular basis whether there is an objective evidence that an investment held to maturity may be impaired. A financial asset is impaired if its carrying amount exceeds its recoverable amount which is equal to the present value of the expected future cash flows discounted at the instrument's original effective interest rate. The amount of impairment loss for assets carried at amortised cost is calculated as the difference between the asset's carrying amount and the present value of the expected future cash flows discounted at the financial instrument's original effective interest method. When an impairment of assets is identified, the Bank recognises allowances through the income statement.

Impairment losses are reversed in subsequent periods when an increase in the recoverable amount can be related objectively to an event occurring after the impairment was recognised, with the restriction that the carrying amount of the investment at the date the impairment is reversed shall not exceed the amount of the amortised cost that would have been recorded, had the impairment not been recognised.

(d) Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than: (a) those that the Bank intends to sell immediately or in the near term, which shall be classified as held for trading, and those that the entity upon initial recognition designates as at fair value through profit or loss; (b) those that the Bank upon initial recognition designates as available for sale; or (c) those for which the Bank may not recover substantially all of its initial investment, other than because of credit deterioration, which shall be classified as available for sale.

This portfolio comprises loans provided to customers.

Loans and receivables are recognised initially at fair value and subsequently measured at amortised cost using the effective interest method, less provision for impairment. Third party expenses, such as legal fees, incurred in securing a loan are treated as part of the cost of the transaction as well as fees received from customers. Loan origination fees for loans which are probable of being drawn down, are deferred (together with related direct costs) and recognized as an adjustment to the effective yield of the loan and as such adjust the interest income.

The Bank assesses at each balance sheet date whether there is objective evidence that a financial asset or a group of financial assets is impaired. A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a loss event) and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated.

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

The criteria that the Bank uses to determine that there is objective evidence of an impairment loss include:

- Delinquency in contractual payments of principal or interest;
- Cash flow difficulties experienced by the borrower (for example, equity ratio, net income percentage of sales);
- Breach of loan covenants or conditions;
- Initiation of bankruptcy proceedings;
- Deterioration of the borrower's competitive position;
- Deterioration in the value of collateral; and
- Downgrading below investment grade level.

(e) Financial liabilities

Financial liabilities of the Bank such as 'Due to banks', 'Deposits from customers', are recognised initially at fair value net of transaction cost incurred. Financial liabilities are subsequently measured at amortized cost using the effective interest method. Interest expense arising on the issue of certificated debts is included in the income statement line 'Interest expense'.

3.8. Financial guarantee contracts

Financial guarantee contracts are contracts that require the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payments when due, in accordance with the terms of a debt instrument. Such financial guarantees are given to banks, financial institutions and other bodies on behalf of customers to secure loans, overdrafts and other banking products. Financial guarantees are initially recognised in the financial statements at fair value on the date the guarantee was given. Subsequent to initial recognition, the bank's liabilities under such guarantees are measured at the higher of the initial measurement, less amortisation calculated to recognise in the income statement the fee income earned on a straight-line basis over the life of the guarantee and the best estimate of the expenditure required to settle any financial obligation arising at the balance sheet date. These estimates are determined based on experience of similar transactions and history of past losses, supplemented by the judgement of the Management Board.

Any increase in the liability relating to guarantees is recognised in the income statement under other operating expenses.

3.9. Derivative financial instruments

Derivative financial instruments include foreign exchange rate forward contracts and are initially recognised in the balance sheet at fair value and subsequently re-measured at their fair value. Fair values are obtained from quoted market prices or pricing models as appropriate. All derivatives are carried as assets when fair value is positive and as liabilities when fair value is negative. Derivative financial instruments include contracts with one-way currency clause. The contracted value is initially recognised in the off-balance-sheet records and as a loan given with a one-way currency clause in the balance sheet. They are subsequently measured at amortised cost as for all other placements that carry credit risk in the balance sheet. Increase in exchange rates (fair value of the embedded derivative) above the contracted, is recorded in the balance sheet as an embedded derivative and recognised within profit or loss from embedded derivatives in the income statement. The Bank's derivative instruments do not qualify for hedge accounting. Changes in the fair value of any derivative instrument that does not qualify for hedge accounting are recognised immediately in the income statement under net trading income. However, the gains and losses arising from changes in the fair value of derivatives that are managed in conjunction with designated financial assets or financial liabilities are included in 'net income from financial assets designated at fair value'.

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

3.10. Sale and repurchase agreements

If a financial asset is sold under an agreement to repurchase it at a fixed price or at the sale price plus a lender's return or if it is loaned under an agreement to return it to the transferor, it is not derecognized as the Bank retains substantially all the risks and rewards of ownership.

3.11. Offsetting of financial instruments

Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right to set off the recognised amounts and there is an intention to settle on a net basis or realise the asset and settle the liability simultaneously.

3.12. Non-current tangible and intangible assets

Non-current tangible and intangible assets are recorded at cost less accumulated depreciation/amortisation. Depreciation/amortisation is calculated on a straight-line basis to write down the cost of such assets to their residual values over their estimated useful lives. Assets under construction are not depreciated.

Depreciation of other assets is calculated using the straight-line method to allocate their cost over their estimated useful lives, as follows:

	2017	2016
	%	%
Property	2.5	2.5
Leasehold improvements	20	20
Electronic equipment	20	20
Other assets	20-25	20-25
Software	20	20
Leasehold improvements	20	20

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date. In addition, the carrying amounts of non-current tangible and intangible assets are reviewed at each balance sheet date to assess whether they are recorded in excess of their recoverable amounts. Where the carrying amount of an asset exceeds its estimated recoverable amount, it is written down immediately to its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. An impairment is recognized in the respective period and is included in operating expenses. After the recognition of an impairment loss the depreciation charge for fixed assets is adjusted in future periods to allocate the assets' revised carrying value, less its residual value (if any), on a systematic basis over its remaining useful life.

Gains and losses on disposals are determined by comparing proceeds with carrying amount. These are included in the income statement.

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

3.13. Leases

The leases entered into by the Bank are operating leases. The total payments made under operating leases are charged to other operating expenses in the income statement on a straight-line basis over the period of the lease. When an operating lease is terminated before the lease period has expired, any payment required to be made to the lessor by way of penalty is recognised as an expense in the period in which the termination takes place.

3.14. Non-current assets held for sale

Non-current assets are classified as assets held for sale and stated at the lower of carrying amount and fair value less costs to sell if their carrying amount is recovered principally through a sale transaction rather than through continuing use.

3.15. Provisions

Provisions are recognised when: the Bank has a present legal or constructive obligation as a result of past events; it is more likely than not that an outflow of resources will be required to settle the obligation; and the amount has been reliably estimated. The Management Board determines the adequacy of the provision based upon reviews of individual items, recent loss experience, current economic conditions, the risk characteristics of the various categories of transactions and other pertinent factors at the balance sheet date. If the effect is material, provisions are discounted to the present value.

Provisions are measured at the present value of the expenditures expected to be required to settle the obligation using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the obligation. Provisions are increased in each period to reflect the passage of time. This increase is recognised as interest expense.

3.16. Employee benefits

The Bank has no post-retirement benefit plans for its employees or management. The Bank makes contributions on behalf of its employees to mandatory state pension plans, which are charged as expense in the period to which they relate. Any future payments to employees are the responsibility of the Republic of Croatia.

3.17. Borrowings

Borrowings are recognised initially at fair value, net of transaction costs incurred. Borrowings are subsequently stated at amortised cost; any difference between the proceeds (net of transaction costs) and the redemption value is recognised in the income statement over the period of the borrowings using the effective interest method.

Borrowings are classified as current liabilities, unless the Bank has an unconditional right to defer settlement of the liability for at least 12 months after the balance sheet date.

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

3.18. Fiduciary activities

Assets and income arising thereon, together with related undertakings to return such assets to customers, are excluded from these financial statements when the Bank acts in a fiduciary capacity such as nominee, trustee or agent.

3.19. Share capital and treasury shares

External costs directly attributable to the issuance of new shares, except for those resulting from business combinations, are deducted from the equity, net of any related taxes.

When the Bank or its associates purchase or become entitled to purchase its share capital, the consideration paid, including all transaction costs less any taxes, is presented as a deduction from the total equity. Gains and losses on the sale of treasury shares are credited and charged, respectively, to treasury shares within equity. The acquisition of treasury shares is recognised within capital at the trade date.

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

4. Net interest income

	2017	2016
	HRK'000	HRK'000
Interest income		
Loans and advances:		
- to customers	73,252	72,017
- to banks	33	1,584
Securities	1,635	3,364
	74,920	76,965
Interest expense		
Deposits from customers	(12,917)	(20,799)
Hybrid instruments	(2,625)	(2,215)
Other borrowed funds	(413)	(685)
	(15,955)	(23,699)
Net interest income	58,965	53,266

5. Net fee and commission income

	2017	2016
	HRK'000	HRK'000
Fee and commission income		
Payment transactions	3,490	3,269
Guarantees and letter of credits given	116	334
Other	3,983	3,064
	7,589	6,667
Fee and commission expense		
Payment transaction fees	(399)	(389)
Other	(2,003)	(1,732)
	(2,402)	(2,121)
Net fee and commission income	5,187	4,546

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

6. Foreign exchange differences – net

	2017	2016
	HRK'000	HRK'000
Net foreign exchange gains on foreign exch. dealing transactions	698	1,340
Foreign exchange gains/(losses) on translation of balance sheet items to middle exchange rate	(58)	192
	640	1,532

7. Other operating income

	2017	2016
	HRK'000	HRK'000
Court costs refund	166	191
Other	1,428	4,140
	1,594	4,331

8. Impairment charge for credit losses - net

	2017	2016
	HRK'000	HRK'000
Loans and advances to customers (Note 18)	12,969	18,252
Collected receivables written off in previous years	(243)	(238)
Other assets (Note 21)	1,055	(752)
Provision for contingent liabilities and commitments (Note 27)	(150)	(73)
	13,631	17,188

9. Administration costs

	2017	2016
	HRK'000	HRK'000
Staff costs		
Net salaries	10,540	10,266
Pension insurance contributions	2,767	2,780
Health insurance contributions	2,643	2,831
Other contributions and taxes on salaries	2,057	2,468
Other staff costs	845	1,005
	18,852	19,350
Other administration costs	9,994	12,749
Impairment of repossessed collaterals	301	6,086
Depreciation and amortisation (Note 19)	1,556	1,877
	30,703	40,062

As at 31 December 2017, the Bank had 97 employees (2016: 104 employees).

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

10. Other operating expenses

	2017	2016
	HRK'000	HRK'000
Rental costs	1,662	1,972
Deposits insurance charge	3,038	3,282
Provisions for legal disputes	11,877	6
Accrued unused vacation	106	(70)
Other	66	1,272
	16,749	6,462

11. Income tax

	2017	2016
	HRK'000	HRK'000
Accounting profit before tax	5,307	432
Effect of items increasing tax base	11,560	12,086
Effect of items decreasing tax base	(4,270)	(4,879)
Tax base	12,597	7,639
Income tax at 18%	2,268	1,528
Effect of tax losses carried forward	(2,268)	(1,528)
Income tax	-	-
Effective tax rate	-	-

Movement of tax losses carried forward was as follows:

	2017	2016
	HRK'000	HRK'000
Tax losses carried forward from the previous period	(117,702)	(136,975)
Utilisation of tax losses	12,598	7,637
Expiration of tax losses carried forward	50,638	11,637
Tax loss available for carry forward in future periods	(54,467)	(117,702)
Deferred tax assets at 18% (2016: 18%)	9,804	21,186
Recognized deferred tax assets (Note 21)	5,463	5,463
Unrecognised deferred tax assets	4,341	15,723

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

Movements in deferred tax assets were as follows:

	2017 HRK'000	2016 HRK'000
At 1 January	5,463	5,463
Reversal of deferred tax assets	(2,268)	(1,528)
Recognition of deferred tax assets	2,268	2,074
At 31 December	5,463	5,463

In 2017, the Bank utilised a portion of its deferred tax assets, i.e. the portion of tax losses carried forward used to settle the current income tax charge. The Bank also recognised deferred tax assets in the same amount on the basis of the conservative estimate of future period planned profits expected to be realised. The Bank has not recognised deferred tax assets in the additional amount of HRK 4,341 thousand in the process of adopting the new 5-year plan.

The Bank may utilise the recorded tax loss in the amount of HRK 54,467 thousand not later than in a period of 5 years:

- tax loss for 2013 in the amount of HRK 43,287 thousand not later than (including) 2019
- tax loss for 2014 in the amount of HRK 11,178 thousand not later than (including) 2020

12. Earnings/(loss) per share**Basic**

Basic earnings per share are calculated by dividing the net loss for the year by the weighted average number of existing shares (ordinary) for the period, excluding treasury shares.

	2017	2016
Profit/(loss) for the year (in HRK'000)	5,307	432
Weighted average number of shares in issue excluding treasury shares	3,527,203	3,433,196
Basic earnings/(loss) per share – ordinary (in HRK)	1.50	0.13

Diluted

Diluted earnings/loss per share for 2017 and 2016 is equal to basic loss per share, since the Bank did not have any convertible instruments or options outstanding during either period.

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

13. Cash on hand and balances with banks

	31 December 2017 HRK'000	31 December 2016 HRK'000
Cash on hand	13,985	15,977
Cash on the clearing account	46,563	48,956
Foreign currency accounts	94,898	100,194
Provisions for unidentified losses on a collective basis	(1,415)	(1,492)
	154,031	163,635

14. Obligatory reserve with the Croatian National Bank

	31 December 2017 HRK'000	31 December 2016 HRK'000
Earmarked obligatory reserve:		
- in HRK	64,483	69,797
- in foreign currency	-	-
Provisions for unidentified losses on collective basis	(645)	(698)
	63,838	69,099

The obligatory reserve rate as at 31 December 2017 was 12% of HRK and foreign currency deposits, loans taken and debt securities issued (31 December 2016: 12%).

15. Placements with banks

	31 December 2017 HRK'000	31 December 2016 HRK'000
Loans	5,138	5,138
Deposits	1,028	1,034
	6,166	6,172
Provisions for identified losses	(5,138)	(5,138)
Provisions for unidentified losses on a collective basis	(10)	(10)
	1,018	1,024

Movement in the provision for identified losses:

	31 December 2017 HRK'000	31 December 2016 HRK'000
At 1 January	5,148	5,530
Additional provisions (Note 8)	-	-
Release of provisions (Note 8)	-	(382)
At 31 December	5,148	5,148

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

16. Loans and advances to customers

	31 December 2017	31 December 2016
	HRK'000	HRK'000
Retail customers	797,335	710,185
Corporate customers	249,375	332,282
Gross loans and advances	1,046,710	1,042,467
Less: Provisions for impairment	(236,712)	(227,578)
Net loans and advances	809,998	814,889
Current portion	74,293	145,954
Non-current portion	735,705	668,937

The movements in the provisions for impairment on loans and advances to customers is as follows:

2017	Retail customers	Corporate customers	Total
	HRK'000	HRK'000	HRK'000
At 1 January	46,898	180,683	227,578
Additional provisions (Note 8)	17,275	11,535	28,810
Collected amounts (Note 8)	(8,328)	(7,408)	(15,736)
Write-offs	(271)	(3,097)	(3,368)
Foreign exchange differences	(142)	(433)	(575)
At 31 December	55,432	181,280	236,712

2016	Retail customers	Corporate customers	Total
	HRK'000	HRK'000	HRK'000
At 1 January	39,696	171,578	211,274
Additional provisions (Note 8)	32,822	72,626	105,448
Collected amounts (Note 8)	(25,677)	(61,519)	(87,196)
Write-offs	(209)	(915)	(1,124)
Foreign exchange differences	266	(1,087)	(821)
At 31 December	46,898	180,683	227,578

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

17. Available-for-sale financial assets

	31 December 2017 HRK'000	31 December 2016 HRK'000
Bonds and treasury bills	42,785	77,219
Corporate bonds	-	-
Equity securities – listed	690	872
Equity securities – unlisted	141	141
	43,616	78,232

Movements in available-for-sale financial assets may be summarised as follows:

	31 December 2017 HRK'000	31 December 2016 HRK'000
At 1 January	78,232	65,362
Additions	33,876	93,267
Disposals	(67,832)	(80,752)
Unrealised gains	66	216
Result of assets available for sale – net	4	469
Interest payment	536	472
Foreign exchange differences	(1,266)	(802)
At 31 December	43,616	78,232

Bonds and treasury bills as at 31 December 2017:

Name	Maturity	Nominal amount (in thousands)	Currency	Carrying amount HRK'000	Unrealised gains/(losses) HRK'000
XS0757376610	21 March 2022	500	EUR	4,204	32
US857524AC63	22 January 2024	500	USD	3,404	(175)
XS0982708926	18 February 2019	200	USD	1,401	(96)
HRRHMFT906X3	7 February 2019	4,500	EUR	33,776	-
				42,785	(239)

As at 31 December 2017, there were no bonds pledged as collateral in repurchase agreements.

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

18. Property and equipment and intangible assets

	Land and buildings	Electronic equipment	Other assets	Total property and equipment	Software	Assets under construction	Leasehold improvements	Total intangible assets
Cost	HRK'000	HRK'000	HRK'000	HRK'000	HRK'000	HRK'000	HRK'000	HRK'000
At 31 December 2015	17,421	6,639	12,024	36,084	8,337	1,150	12,570	22,057
Additions	-	60	826	886	123	1,173	2,337	3,633
Transfers	-	-	-	-	-	(2,323)	-	(2,323)
Disposals	-	(4)	(59)	(63)	-	-	-	-
At 31 December 2016	17,421	6,695	12,791	36,256	8,461	-	14,907	23,367
Additions	-	266	5	271	174	449	195	818
Transfers	-	-	-	-	-	(110)	-	(110)
Disposals	(187)	(538)	(195)	(920)	-	-	-	-
At 31 December 2017	17,234	6,420	12,602	32,256	8,635	339	15,102	24,076
Accumulated depreciation/amortisation								
At 31 December 2015	2,899	6,405	11,524	20,828	7,619	-	11,957	19,576
Depreciation/amortisation charge for the period	304	94	228	626	519	-	734	1,253
Disposals	-	(4)	(20)	(24)	-	-	-	-
At 31 December 2016	3,203	6,495	11,732	21,430	8,138	-	12,691	20,829
Depreciation/amortisation charge for the period	302	98	257	657	314	-	585	899
Disposals	(8)	(534)	(195)	(737)	-	-	-	-
At 31 December 2017	3,497	6,059	11,793	21,349	8,451	-	13,275	21,726
Net book amount								
At 31 December 2016	14,218	200	1,059	15,477	322	-	2,216	2,538
At 31 December 2017	13,737	361	809	14,907	184	339	1,827	2,350

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

19. Repossessed collateral

Movements in repossessed collateral during the year:

	31 December 2017 HRK'000	31 December 2016 HRK'000
At 1 January	37,301	37,868
Additions	-	7,457
Disposals	(4,368)	(1,938)
Impairment	-	(6,086)
At 31 December	32,933	37,301

The Bank's repossessed collateral as at 31 December 2017 included property in the total amount of HRK 3,357 thousand (2016: HRK 3,357 thousand) which was not in the Bank's possession. The Bank took over formal ownership over the property in exchange for outstanding receivables in the process of obtaining physical possession.

20. Other assets

	31 December 2017 HRK'000	31 December 2016 HRK'000
Deferred tax assets	5,463	5,463
Receivables for court costs refunds	6,803	5,032
Trade receivables	4,078	70
Other prepayments	189	273
Prepaid expenses	1,924	1,666
Court receivables for sold property	7,947	11,099
Other	4,794	3,150
	31,198	26,753
Provision for identified losses	(8,646)	(8,123)
Provision for unidentified losses on collective basis	(152)	(115)
	22,400	18,515

Movement in the provision for identified losses during the year:

	31 December 2017 HRK'000	31 December 2016 HRK'000
At 1 January	8,239	8,404
Additional provisions (Note 8)	2,201	2,820
Collected amounts (Note 8)	(1,125)	(2,934)
Write-off	(517)	(51)
At 31 December	8,798	8,239

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

21. Deposits from customers

Deposits comprise demand deposits and term deposits:

	31 December 2017 HRK'000	31 December 2016 HRK'000
Demand deposits		
Corporate customers	7,527	12,240
Retail customers	149,671	146,804
	157,198	159,044
Term deposits		
Corporate customers	4,612	6,636
Retail customers	786,554	848,235
	791,166	854,871
Deposits from customers	948,364	1,013,915
Current portion	601,010	811,610
Non-current portion	347,355	202,305

22. Due to banks

	31 December 2017 HRK'000	31 December 2016 HRK'000
Borrowings:		
- Croatian Bank for Reconstruction and Development	8,235	16,002
Deposits	426	7,467
	8,661	23,469
Current portion	426	7,467
Non-current portion	8,235	16,002

As at 31 December 2017 and 31 December 2016, all deposits from banks are current.

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

23. Hybrid instruments

Hybrid financial instruments represent special term deposits from citizens and legal entities with no option of cancellation prior to maturity, except for the purpose of purchasing shares of the Bank, and which are under certain conditions, prescribed by the Croatian National Bank, calculated within the Bank's regulatory capital.

	31 December 2017 HRK'000	31 December 2016 HRK'000
Foreign entities	30,151	30,070
Domestic entities	9,730	9,787
	39,881	39,857

24. Repurchase agreements

As at 31 December 2017 and 31 December 2016, the Bank did not have any repurchase agreements.

25. Other liabilities

	31 December 2017 HRK'000	31 December 2016 HRK'000
Provisions for legal disputes	12,341	472
Provision for contingent liabilities and commitments	148	298
Payables in the course of settlement	8,143	6,178
Trade payables	843	821
Employee payables – salaries and contributions	1,488	1,721
Liabilities for deposits insurance charge	737	808
Accrued unused vacation (Note 10)	305	199
Other liabilities	7,228	1,395
	31,233	11,892

Movement in provisions for legal disputes:

	31 December 2017 HRK'000	31 December 2016 HRK'000
At 1 January	471	629
Additional provisions	11,927	75
Release of provisions	(51)	(69)
Payments made per court verdicts	(7)	(163)
At 31 December	12,340	471

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

Movement in provisions for contingent liabilities and commitments:

	31 December 2017 HRK'000	31 December 2016 HRK'000
At 1 January	298	368
Additional provisions	850	1,564
Release of provisions	(1,000)	(1,634)
At 31 December	148	298

26. Shareholders' equity**Share capital**

As at 31 December 2017, the Bank's share capital amounted to HRK 106,962 thousand (31 December 2016: HRK 103,943 thousand), and it is divided among 3,565,397 ordinary shares (31 December 2016: 3,464,787) (VSK-R-A) with a nominal value of HRK 30 per share.

The Bank's main shareholders as at 31 December were as follows:

Shareholder	31 December 2017		31 December 2016	
	Number of shares	% in share capital	Number of shares	% in share capital
Cassa di Risparmio della Repubblica di San Marino	3,554,514	99.69	3,453,904	99.69
Treasury shares	153	0.00	153	0.00
Other	10,730	0.31	10,730	0.31
Total	3,565,397	100.00	3,464,787	100.00

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

27. Cash and cash equivalents

For the purposes of the statement of cash flows, cash and cash equivalents comprise the following balances with less than 90 days maturity:

	Note	31 December 2017	31 December 2016
		HRK'000	HRK'000
Cash on hand and balances with banks	13	154,031	163,635
Placements with banks	15	1,018	1,024
		155,049	164,659

28. Contingent liabilities and commitments**Legal disputes**

The Bank is currently subject to 13 legal proceedings. As at 31 December 2017, provisions for legal disputes for which the Bank anticipates an outflow of economic benefits amount to HRK 12,340 thousand (2016: HRK 472 thousand). Total contingent liabilities arising from the dispute with the company Prvi Faktor d.o.o. per the instituted enforcement proceedings against the Bank in the amount of EUR 710 thousand as at 31 December 2017 amounted to HRK 10,654 thousand, and the total provisions for contingent liabilities arising from the dispute amounted to HRK 11,982 thousand. It is a guarantee issued by the Bank in favour of the company Prvi Faktor d.o.o. for the loan payment to the company Glas Istre d.o.o. The first-instance court ruling was issued in the Bank's favour, rejecting the plaintiff's claim. The second-instance court ruling was issued in the plaintiff's favour, and the case was under extraordinary revision at the time these financial statements were issued.

Capital commitments

As at 31 December 2017 and 31 December 2016, the Bank had no capital commitments in respect of purchases of buildings and equipment.

Loan commitments, guarantees and other financial instruments

The following table indicates the contractual amounts of the Bank's off-balance sheet financial instruments:

	31 December 2017	31 December 2016
	HRK'000	HRK'000
Guarantees	556	5,639
Letters of credit	-	11,095
Loan and other commitments	14,247	13,111
Less: Provision for contingent liabilities and commitments (Note 26)	-	-
Total	14,803	29,845

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

The primary purpose of these instruments is to ensure that funds are available to a customer as required. Guarantees and standby letters of credit, which represent irrevocable assurance that the Bank will make payments in the event that customer cannot meet its obligations to third parties, carry the same credit risks as loans given.

Commitments to lend represent unused portions of authorisations to lend in the form of loans or guarantees. With respect to credit risk on commitments to lend, the Bank is potentially exposed to loss in an amount equal to the total unused commitments. However, the likely amount of loss is less than the total unused commitments, as most commitments to lend are contingent upon customers maintaining specific credit standards.

Guarantees and undrawn loan commitments are subject to similar credit risk monitoring and credit policies as utilised in the approval of loans. The Management Board of the Bank believes that the market risk associated with guarantees and undrawn loan commitments is minimal.

Operating lease commitments where the Bank is the lessee

The future minimum lease payments receivable from operating leases are as follows:

	31 December 2017	31 December 2016
	HRK'000	HRK'000
Up to 1 year	1,807	1,814
From 2 to 5 years	5,289	5,850
Over 5 years	2,471	3,233
Total	9,567	10,897

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

29. Related party transactions

Parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial or operational decisions. Related-party transactions are part of the normal course of business.

The Bank considers itself to be an immediately related person to its major shareholders, their subsidiaries, Supervisory and Management Board members and their close family members.

In 2017 and 2016, transactions with related parties were as follows:

	Supervisory Board, Management Board and their related parties	
	2017	2016
	HRK'000	HRK'000
Income and expenses		
Interest income	3	2
Interest expense	25	33
Loans		
At 1 January	120	1,241
Increase	-	70
Decrease	-	(1,191)
At 31 December	120	120
Deposits received		
At 1 January	3,085	1,406
Increase	2,077	1,731
Decrease	(2,411)	(52)
At 31 December	2,751	3,085

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

	Cassa di Risparmio della Repubblica di San Marino	
	2017	2016
	HRK'000	HRK'000
Income and expenses		
Interest income	1	61
Other operating income	466	6
Interest expense	(1,116)	(765)
Given deposits and cash		
At 1 January	4	19,115
Increase	1,220	-
Decrease	-	(19,111)
At 31 December	1,224	4
Deposits received		
At 1 January	1,428	1,082
Increase	-	346
Decrease	(1,255)	-
At 31 December	173	1,428
Hybrid instruments		
At 1 January	17,543	14,818
Increase	170	2,725
Decrease	(16)	-
At 31 December	17,697	17,543

As at 31 December 2017, the exposure towards the majority shareholder amounts to HRK 1,224 thousand, which represents 0.88% of the Bank's regulatory capital (2016: 0.00%, 2015: 15.36%). The regulatory limit exposure to one person or Group of related persons is a maximum of 25% of the regulatory capital of a credit institution.

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

	Nekretnine plus d.o.o.	
	2017	2016
	HRK'000	HRK'000
Income and expenses		
Interest income	318	333
Other operating income	116	111
Interest expense	(670)	(675)
Loans given		
At 1 January	6,188	6,285
Increase	116	-
Decrease	(102)	(97)
At 31 December	6,202	6,188
Deposits received		
At 1 January	1,024	764
Increase	36	260
Decrease	(239)	-
At 31 December	821	1,024
Hybrid instruments		
At 1 January	9,787	9,887
Increase	-	-
Disposals	(57)	(100)
At 31 December	9,730	9,787

Key management and Supervisory Board compensation

	31 December	31 December
	2017	2016
	HRK'000	HRK'000
Gross salaries and other short-term benefits	3,893	3,879

30. Financial risk management

The Bank's activities are exposed to a variety of financial and operational risks, the management of which includes the analysis, evaluation, acceptance and management to some degree of risk or combination of risks. Risk management and risk acceptance represents the basic merit of financial operations. The Bank's aim is therefore to achieve an appropriate balance between risk and return and minimise potential adverse effects on the Bank's financial performance.

The Bank's risk management policies are designed to identify and analyse these risks, to set appropriate risk limits and controls, and to monitor the risks and adherence to limits by means of reliable and up-to-date information systems. The Bank regularly reviews its risk management policies and systems to reflect changes in market, products and emerging best practise.

Risk management is the responsibility of the Management Board and the Assets and Liabilities Committee (ALCO) and the Committee for credit risk management (RICO). Management identifies, evaluates and hedges financial risks in close co-operation with the Bank's operating units. The Management Board provides written principles for overall risk management, as well as written policies covering specific areas, such as currency risk, interest rate risk, credit risk, liquidity risk, price risk, operational risk and use of derivative and non-derivative financial instruments. In addition, the Internal Audit Department is responsible for the independent review of risk management and the control environment.

The most important types of risk are credit risk, liquidity risk, market risk and operational risk. Market risk includes currency risk, interest rate and other types of price risk.

31.1 Credit risk

The Bank is exposed to credit risk, which is the risk that a counterparty will be unable to settle its obligations in full when due. Significant changes in the economy, or in the particular industry segment that represents a concentration in the Bank's portfolio, could result in losses that are different from those provided for at the balance sheet date. The Management Board therefore carefully manages its exposure to credit risk. Credit exposures arise principally in loans and advances, debt and other securities. There is also credit risk in off-balance-sheet financial arrangements such as loan commitments and other issued guarantees. The credit risk management and control are centralised within the Risk Management Sector.

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

31.1.1. Credit risk measurement

(a) Loans and advances

When granting loans and advances to customers and loans to banks according to the contract, the Bank estimates and measures credit risk based on:

1. assessment of counterparty's credit worthiness,
2. assessment of counterparty's regularity in obligations settlement and
3. quality of collateral.

The Bank assesses the counterparty's credit worthiness using the external rating tools. The tools combine statistical analysis with financial advisor judgement and are validated, where appropriate, by comparison with externally available data. Financial analyst exposures for all groups over EUR 150 thousand based on the collected data and indicators must make an opinion on the financial position of the client, and give their opinion regarding the approval. The Bank's placements to customers are segmented into three rating classes; fully recoverable placements, partially recoverable and unrecoverable placements.

Settlement of obligations means the payment of all liabilities within contractual maturity terms, without establishing new receivables in that respect.

The quality of collateral is established based on market effectiveness, the existence of documentation and the possibility of forced collection.

(b) Debt securities and other bills

For debt securities and other bills, external rating such as Standard & Poor's, Moody's, Fitch/BCA rating or their equivalents are used by the Treasury Sector, if available. The investments in those securities and bills are viewed as a way to gain a better credit quality mapping and maintain a readily available source to meet the funding requirement at the same time.

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

31.1.2. Risk limit control and mitigation policies

The Bank manages, limits and controls concentrations of credit risk wherever they are identified – in particular, with respect to individual counterparties and groups, and to industries and countries.

The Bank structures the level of credit risk it undertakes by placing limits on the amount of risk accepted in relation to one borrower, his related parties and industry segments. Limits on the level of credit risk by industry sector are subject to an annual or more frequent review, when considered necessary.

Exposure to credit risk is also managed through regular analysis of the ability of borrowers and potential borrowers to meet all obligations towards the Bank, and by changing these lending limits where appropriate.

Some other specific control and mitigation measures are outlined below:

(a) Collateral

The Bank employs a range of policies and practices to mitigate credit risk. The most traditional of these is the taking of security for certain types of placements. The Bank has internal regulations in place on the acceptability of specific classes of collateral or credit risk mitigation. The principal collateral types are:

- Mortgages over residential properties;
- Mortgages over business assets such as premises, inventory and receivables, equipment;
- Mortgages over financial instruments such as debt and equity securities.

Debt securities, treasury and other eligible bills are generally unsecured.

(b) Commitments related to loans

The primary purpose of these instruments is to ensure that funds are available to a customer as required. Guarantees carry the same credit risk as loans. Commitments to extend credit represent unused portions of authorisations to extend credit in the form of loans or guarantees. With respect to credit risk on commitments to extend credit, the Bank is potentially exposed to loss in an amount equal to the total unused commitments. However, the likely amount of loss is less than the total unused commitments, as most commitments to extend credit are contingent upon customers maintaining specific credit standards. The Bank monitors the term to the maturity of credit commitments because longer-term commitments generally have a greater degree of credit risk than shorter-term commitments.

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

31.1.3. Impairment and provisioning policies

Impairment provisions are recognised for financial reporting purposes only for losses that have been incurred at the balance sheet date based on objective evidence of impairment.

The impairment provision shown in the balance sheet at year-end is derived from each of the three internal rating grades. However, the majority of the impairment provision comes from the bottom two grades. The table below shows the percentage of balance items of the Bank's on-balance sheet items relating to loans and advances to customers, and the associated impairment provision for each of the Bank's internal rating categories:

Bank's rating

	2017		2016	
	Loans and advances	Provisions for impairment	Loans and advances	Provisions for impairment
	HRK'000	HRK'000	HRK'000	HRK'000
1. Fully recoverable placements	768,816	7,688	742,147	7,422
2. Partially recoverable placements	126,607	77,737	159,474	79,309
3. Unrecoverable placements	151,287	151,287	140,847	140,847
	1,046,710	236,712	1,042,468	227,578

Bank's rating

	2017		2016	
	Loans and advances (%)	Provision for impairment (%)	Loans and advances (%)	Provision for impairment (%)
	HRK'000	HRK'000	HRK'000	HRK'000
1. Fully recoverable placements	73.45	3.25	71.19	3.26
2. Partially recoverable placements	12.10	32.84	15.30	34.85
3. Unrecoverable placements	14.45	63.91	13.51	61.89
	100.00	100.00	100.00	100.00

The internal rating tool assists the Management Board to determine whether objective evidence of impairment exists, based on the following criteria set out by the Bank:

- Delinquency in contractual payments of principal, interest or fee;
- Cash flow difficulties experienced by the borrower (e.g. equity ratio, net income percentage of sales);
- Breach of loan covenants or conditions approved loans;
- Initiation of bankruptcy proceedings;
- Deterioration in the value of collateral.

The Bank's policy requires the review of individual financial assets that are above materiality thresholds at least annually or more regularly when individual circumstances require. Impairment allowances on individually assessed accounts are determined by an evaluation of the incurred loss at balance sheet date on a case-by-case basis, and are applied to all individually significant accounts. The assessment normally encompasses collateral held (including re-confirmation of its enforceability) and the anticipated receipts for that individual account.

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

31.1.4. Maximum exposure to credit risk before collateral held or other credit enhancements

	31 December 2017 HRK'000	31 December 2016 HRK'000
Credit risk exposure relating to balance sheet assets		
Cash on hand and balances with banks	154,031	163,635
Obligatory reserve with the Croatian National Bank	63,838	69,099
Placements with banks	1,018	1,024
Loans and advances to customers	809,998	814,889
Available-for-sale financial assets	43,617	78,232
Other assets	22,400	18,515
	1.094.902	1,145,395
Credit risk exposure relating to off-balance-sheet assets		
Financial guarantees	556	5,639
Letters of credit	-	11,095
Loan commitments and other credit related liabilities	14,247	13,111
	14,803	29,845

The above table represents Bank's maximum exposure to credit risk as at 31 December 2017 and 2016, without taking into account any collateral held or other credit enhancements attached. For balance sheet items, exposures set out above are based on net carrying amounts as reported in the balance sheet. As indicated above, 74.07% of the total maximum exposure is derived from loans and advances to banks and customers (2016: 71.23%).

31.1.5 Loans and advances

Loans and advances are summarised as follows:

	31 December 2017		31 December 2016	
	Loans and advances to customers HRK'000	Loans and advances to banks HRK'000	Loans and advances to customers HRK'000	Loans and advances to banks HRK'000
Neither past due nor impaired	751,524	1,028	733,225	1,034
Past due but not impaired	17,293	-	8,921	-
Individually impaired	277,893	5,138	300,322	5,138
Gross	1,046,710	6,166	1,042,468	6,172
Less: provision for impairment	(236,712)	(5,149)	(227,578)	(5,148)
Net	809,998	1,018	814,889	1,024

The total impairment provision for loans and advances is HRK 236,712 thousand (2016: HRK 227,578 thousand) of which HRK 229,024 thousand (2016: HRK 220,122 thousand) represents the individually impaired loans and the remaining amount of HRK 7,688 thousand (2016: HRK 7,456 thousand) represents the provision for fully recoverable placements portfolio. Further information of the impairment provision for loans and advances to banks and to customers is provided in Notes 15 and 16.

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

The breakdown of the gross amount of loans and advances by class held by the Bank are as follows:

	Retail customers	Corporate customers	Total loans and advances to customers	Loans and advances to banks
	HRK'000	HRK'000	HRK'000	HRK'000
31 December 2017				
<i>Neither past due nor impaired</i>				
Fully recoverable placements	717,212	34,312	751,524	1,028
<i>Past due but not impaired</i>				
Past due up to 30 days	1,845	122	1,967	-
Past due from 30 to 90 days	9,146	6,180	15,326	-
<i>Individually impaired</i>				
Individually impaired loans	69,132	208,761	277,893	5,138
Total	797,335	249,375	1,046,710	6,166

	Retail customers	Corporate entities	Total loans and advances to customers	Loans and advances to banks
	HRK'000	HRK'000	HRK'000	HRK'000
31 December 2016				
<i>Neither past due nor impaired</i>				
Fully recoverable placements	634,620	98,605	733,225	1,034
<i>Past due but not impaired</i>				
Past due up to 30 days	2,011	338	2,349	-
Past due from 30 to 90 days	2,463	4,110	6,573	-
<i>Individually impaired</i>				
Individually impaired loans	71,092	229,229	300,321	5,138
Total	710,185	332,282	1,042,468	6,172

Loans and advances less than 90 days past due are not considered impaired, unless other information is available to indicate the contrary. Upon initial recognition of loans and advances, the fair value of collateral is based on valuation techniques commonly used for the corresponding assets. In subsequent periods, the fair value is updated on the basis of market prices or indexes of similar assets.

31.1.6 Repossessed collateral

Reposessed collateral is sold as soon as practicable with the proceeds used to reduce the outstanding debt.

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

31.1.7 Concentration of risks of financial assets with credit risk exposure

(a) Geographical sectors

The following table breaks down the Bank's main credit exposure at their carrying amounts, as categorised by geographical region as at 31 December 2017. For this table, the Bank has allocated exposures to regions based on the country of domicile of its counterparties.

	Croatia	European Union	Other countries	Total
	HRK'000	HRK'000	HRK'000	HRK'000
Cash on hand and balances with banks	143,750	9,069	1,213	154,031
Obligatory reserve with the Croatian National Bank	63,838	-	-	68,838
Placements with banks	1,018	-	-	1,018
Loans and advances to customers	808,610	1,388	-	809,998
Available-for-sale assets	34,607	9,009	-	43,617
Other assets	22,393	-	7	22,400
At 31 December 2017	1,074,215	19,467	1,220	1,094,902
At 31 December 2016	1,130,337	15,045	13	1,145,395

(b) Industry sectors

The following table breaks down the Bank's main credit exposure at their carrying amounts, as categorised by the industry sectors of our clients.

	Financial institutions	Manufacturing	Properties	Wholesale and retail trade	Public sector	Other industries	Individuals	Total
	HRK'000	HRK'000	HRK'000	HRK'000	HRK'000	HRK'000	HRK'000	HRK'000
Placements with banks	1,018	-	-	-	-	-	-	1,018
Loans and advances to customers	-	13,075	17,004	20,286	5,507	17,038	737,089	809,998
Available-for-sale assets	9,330	4	207	124	33,776	174	-	43,617
Other assets	11,725	13	158	33	1,655	641	8,176	22,400
At 31 December 2017	22,073	13,091	17,369	20,444	40,937	17,853	745,265	877,033
At 31 December 2016	19,870	25,988	57,943	33,260	91,344	25,621	658,636	912,661

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

32. Market risk

The Bank is exposed to market risks, which is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risks arise from open positions in interest rate, currency and equity products, all of which are exposed to general and specific market movements and changes in the level of volatility of market rate or prices such as interest rates, credit spreads, foreign exchange rate and equity prices. The Bank separates exposures to market risk into either trading or non-trading portfolios.

The market risks arising from trading and non-trading activities are concentrated in the Treasury Division. Regular reports are submitted to the Management Board and heads of each business unit.

Trading portfolios include those positions arising from market-making transactions where the Bank acts as principal with clients or with the market.

Non-trading portfolios primarily arise from the interest rate management of the entity's retail and commercial banking assets and liabilities. Non-trading portfolios also consist of foreign exchange and equity risks arising from the Bank's available-for-sale investments held to maturity.

The matching and controlled mismatching of the maturities and interest rates of assets and liabilities is fundamental to the Management Board of the Bank. It is unusual for banks ever to be completely matched since business transacted is often of uncertain term and of different types. An unmatched position potentially enhances profitability, but can also increase the risk of losses.

The maturities of assets and liabilities and the ability to replace, at an acceptable cost, interest-bearing liabilities as they mature, are important factors in assessing the liquidity of the Bank and its exposure to changes in interest rates and exchange rates.

Liquidity requirements to support guarantee payments and standby letters of credit are considerably less than the amount of the commitment because the Bank does not generally expect the third party to draw funds under the agreement. The total outstanding contractual amount of commitments to extend credit at the balance sheet date does not necessarily represent future cash flows, since many of these commitments will expire or be terminated without being funded.

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

32.1. Foreign exchange risk

The Bank is exposed to the effects of fluctuations in the prevailing foreign currency exchange rates on its financial position and cash flows. The Bank manages its currency risk by setting principles and limits for foreign currency exposures and by monitoring exposure with respect to limits. The Bank directs its business activities trying to minimise the gap between assets and liabilities denominated in or linked to foreign currency, and maintaining the daily business activities within daily potential loss limits. The parameters are regularly reviewed in accordance with fluctuations in foreign currency rates and correlations between currencies.

The table below summarises the Bank's exposure to currency risk as at 31 December. Included in the table are the Bank's financial instruments at carrying amounts, categorised by currency.

Concentrations of currency risk – on- and off-balance sheet financial instruments

	HRK	EUR	USD	Other currencies	Total
	HRK'000	HRK'000	HRK'000	HRK'000	HRK'000
At 31 December 2017					
Assets					
Cash on hand and balances with banks	55,829	91,587	1,454	5,162	154,032
Obligatory reserve with the CNB	63,838	-	-	-	63,838
Placements with banks	-	1,018	-	-	1,018
Loans and advances to customers	150,720	659,278	-	-	809,998
Available-for-sale financial assets	831	37,980	4,805	-	43,617
Other assets	18,405	3,730	31	234	22,400
Total financial assets	289,623	793,593	6,290	5,396	1,094,902
Liabilities					
Deposits from customers	179,417	757,475	6,134	5,339	948,364
Due to banks	755	7,906	-	-	8,661
Hybrid instruments	-	39,881	-	-	39,881
Other liabilities	30,753	480	-	-	31,233
Total financial liabilities	210,925	805,742	6,134	5,339	1,028,139
Net balance-sheet gap	78,698	(12,149)	156	57	66,763
Loan commitments	6,594	7,653	-	-	14,247
At 31 December 2016					
Total financial assets	293,911	836,985	7,967	6,532	1,145,395
Total financial liabilities	228,380	846,203	8,040	6,510	1,089,133
Net balance-sheet gap	65,531	(9,218)	(73)	22	56,262
Loan commitments	7,299	5,813	-	-	13,112

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

32.2. Interest rate risk

Cash flow interest rate risk is the risk that the future cash flows of financial instruments will fluctuate because of changes in market interest rates. Fair value interest rate risk is the risk that the value of the financial instrument will fluctuate because of changes in market interest rates. The Bank is exposed to the effects of fluctuations in the prevailing levels of market interest rates on both its fair value and cash flow risks. Interest spreads may increase as a result of such changes, but may also reduce losses in the event that unexpected movements arise. The Management Board sets limits on the level of mismatch of interest rates repricing that may be undertaken, which is monitored daily by the Bank's Treasury.

The table below summarises the Bank's exposure to interest rate risks. Included in the table are the Bank's assets and liabilities at carrying amounts, categorised by the earlier of contractual repricing or maturity dates.

	Up to 1 month	1 - 3 months	3 - 12 months	1 - 3 years	Over 3 years	Non- interest bearing	Total
	HRK'000	HRK'000	HRK'000	HRK'000	HRK'000	HRK'000	HRK'000
At 31 December 2017							
Assets							
Cash on hand and balances with banks	-	-	-	-	-	154,032	154,032
Obligatory reserve with the CNB	-	-	-	-	-	63,838	63,838
Placements with banks	-	-	-	-	-	1,018	1,018
Loans and advances to customers	45,639	7,741	19,386	40,284	691,828	5,121	809,998
Available-for-sale financial assets	-	-	-	33,776	-	9,841	43,617
Other assets	-	-	-	-	-	22,400	22,400
Total financial assets	45,639	7,741	19,386	74,059	691,828	256,249	1,094,902
Liabilities							
Deposits from customers	110,327	84,455	318,683	240,706	83,226	110,968	948,364
Due to banks	1,145	-	690	-	6,400	426	8,661
Hybrid instruments	-	-	-	9,730	30,151	-	39,881
Other liabilities	-	-	-	-	-	31,233	31,233
Total financial liabilities	111,472	84,455	319,373	250,436	119,776	142,627	1,028,139
Net balance-sheet gap	(65,833)	(76,714)	(299,987)	(176,377)	572,051	113,622	66,763
At 31 December 2016							
Total financial assets	61,861	48,303	111,965	41,605	624,279	257,382	1,145,395
Total financial liabilities	138,611	117,861	453,839	144,095	108,331	126,396	1,089,133
Net balance-sheet gap	(76,749)	(69,559)	(341,873)	(102,490)	515,948	130,985	56,262

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

32.3. Liquidity risk

Liquidity risk is the risk that the Bank will be unable to meet its payment obligations associated with its financial liabilities when they fall due and to replace funds when they are withdrawn. The consequence may be the failure to meet obligations to repay depositors and fulfil commitments to lend.

The Bank is exposed to daily calls on its available cash resources from overnight deposits, current accounts, maturing deposits, loan draw downs and other calls on cash. The Bank does not maintain cash resources to meet all of these needs as experience shows that the minimum level of reinvestment of maturing funds can be predicted with a high level of certainty. The Bank manages liquidity reserves daily, ensuring also meeting all customer needs.

32.3.1. Funding approach

Sources of liquidity are regularly reviewed by the Bank's Treasury to maintain a wide diversification by currency, geography, provider, product and term.

32.3.2. Non-derivative cash flows

The table below presents the cash flows payable by the Bank under non-derivative financial liabilities by remaining contractual maturities at the balance sheet date.

31 December 2017	Up to 1 month HRK'000	1 - 3 months HRK'000	3 - 12 months HRK'000	1 - 3 years HRK'000	Over 3 years HRK'000	Total HRK'000
Deposits from customers	221,062	84,455	318,683	240,782	83,383	948,364
Due to banks	1,571	-	690	-	6,400	8,661
Hybrid instruments	-	-	-	9,730	30,151	39,881
Other liabilities	18,441	14	12,696	5	78	31,233
Total liabilities (contractual maturity dates)	241,074	84,469	332,069	250,516	120,011	1,028,139
Total liabilities on unused loans (expected maturity dates)	929	1,386	4,233	502	7,752	14,803

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

31 December 2016	Up to 1 month HRK'000	1 - 3 months HRK'000	3 - 12 months HRK'000	1 - 3 years HRK'000	Over 3 years HRK'000	Total HRK'000
Deposits from customers	243,988	117,868	453,857	142,553	55,648	1,013,915
Due to banks	8,834	-	-	1,610	13,025	23,469
Hybrid instruments					39,857	39,857
Other liabilities	10,902	74	855	5	56	11,892
Total liabilities (contractual maturity dates)	263,724	117,943	454,712	144,168	108,586	1,089,133
Total liabilities on unused loans (expected maturity dates)	1,028	1,214	4,734	547	5,588	13,111

Assets available to meet all of the liabilities and to cover outstanding loan commitments include cash, central bank balances, items in the course of collection and treasury and other eligible bills; loans and advances to banks; and loans and advances to customers. In the normal course of business, a proportion of customer loans contractually repayable within one year will be extended. The Bank would also be able to meet unexpected net cash outflows by selling securities and approaching other funding sources.

32.3.3. Off-balance-sheet items

(a) Loan commitments

The dates of the contractual amounts of the Bank's off-balance-sheet financial instruments that commit it to extend credit to customers and other financial instruments (Note 29) are summarised in the table below.

(b) Other financial instruments

Other financial instruments (Note 29) are also included below based on the earliest contractual maturity date.

	No later than 1 year HRK'000	1 to 3 years HRK'000	Over 3 years HRK'000	Total HRK'000
31 December 2017				
Loan commitments	5,992	8,254	-	14,247
Guarantees, letters of credit and other	557	-	-	556
Total	6,549	8,254	-	14,803
31 December 2016				
Loan commitments	6,976	6,135	-	13,111
Guarantees, letters of credit and other	16,734	-	-	16,734
Total	23,710	6,135	-	29,845

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

The matching and controlled mismatching of the maturities and interest rates of assets and liabilities is fundamental to the Management Board of the Bank. It is unusual for banks ever to be completely matched since business transacted is often of uncertain term and of different types. An unmatched position potentially enhances profitability, but can also increase the risk of losses.

The maturities of assets and liabilities and the ability to replace, at an acceptable cost, interest-bearing liabilities as they mature, are important factors in assessing the liquidity of the Bank and its exposure to changes in interest rates and exchange rates.

Liquidity requirements to support guarantee payments and standby letters of credit are considerably less than the amount of the commitment because the Bank does not generally expect the third party to draw funds under the agreement. The total outstanding contractual amount of commitments to extend credit at the balance sheet date does not necessarily represent future cash flows, since many of these commitments will expire or be terminated without being funded.

32.4. Fair value of financial assets and liabilities

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. Fair value is based on quoted market prices, where available. However, no readily available market prices exist for a significant portion of the Bank's financial instruments. In circumstances where the quoted market prices are not readily available, the fair value is estimated using discounted cash flow models or other pricing techniques as appropriate. Changes in assumptions on which the estimates are based, including discount rates and estimated future cash flows, significantly affect the estimates. Therefore, the calculated fair market estimates may not be realisable in a current sale of the financial instrument.

The Bank uses the following hierarchy for determining the fair value of financial instruments by using valuation techniques:

- level 1: quoted prices (unadjusted) in active markets for identical assets or liabilities
- level 2: other techniques for which all inputs which have a significant effect on the recorded fair value are observable, either directly or indirectly
- level 3: techniques which use inputs which have a significant effect on the recorded fair value that are not based on observable market data

	31 December 2017			31 December 2016		
	Level 1	Level 2	Total	Level 1	Level 2	Total
	HRK'000	HRK'000	HRK'000	HRK'000	HRK'000	HRK'000
Bonds	42,785	-	42,785	77,219	-	77,219
Shares	690	141	831	872	141	1,013
	43,475	141	43,616	78,091	141	78,232

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

The table below summarises the carrying amounts and fair values of financial assets and liabilities not presented on the Bank's balance sheet at their fair value.

	Carrying amount		Fair value	
	2017	2016	2017	2016
	HRK'000	HRK'000	HRK'000	HRK'000
Financial assets				
Placements with banks	1,018	1,024	1,018	1,024
Loans and advances to customers	809,998	814,890	809,998	814,890
Other assets	22,400	18,515	22,400	18,515
Total financial assets	833,416	834,429	833,416	834,429
Financial liabilities				
Deposits from customers	948,364	1,013,915	948,364	1,013,915
Due to banks	8,661	23,469	8,661	23,469
Hybrid instruments	39,881	39,857	39,881	39,857
Other liabilities	31,233	11,892	25,242	11,892
Total financial liabilities	1,028,139	1,089,133	1,022,148	1,089,133

For the purpose of the fair value assessment of the Bank's financial instruments the following methods and assumptions have been used:

(a) Cash and funds with Central bank

The carrying amount of cash and amounts due from banks, obligatory reserve with the Croatian National Bank, and placements with banks, deposits from banks and deposits from companies and similar entities are deemed to reflect their fair value due to the short-term maturity of these financial instruments.

(b) Held-to-maturity financial assets

The fair value of securities held-to-maturity is calculated based on quoted market prices.

(c) Due from other banks

The estimated fair values of amounts due from other banks, which mature within a maximum of 180 days approximate their carrying amounts. The fair values of other amounts due from banks is estimated based on discounted cash flow analyses using prevailing interest rates for investments under similar terms (market rates adjusted by credit risk). The fair value of non-performing amounts due from banks is estimated using a discounted cash flow analysis. Allowances are not taken into consideration when calculating fair values.

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

(d) Loans to and receivables from customers

The fair value of variable yield loans that regularly reprice, with no significant change in credit risk, generally approximates their carrying value. The fair value of loans at fixed interest rates is estimated using discounted cash flow analyses, based upon interest rates currently offered for loans with similar terms to borrowers of similar credit quality. The fair value of non-performing loans to customers is estimated using a discounted cash flow analysis or the appraised value of the underlying collateral, where available. Loans at fixed interest rates represent only a fraction of the total carrying value and hence the fair value of total loans to and receivables from customers approximates the carrying values as at the balance sheet date. Allowances are not taken into consideration when calculating fair values.

(e) Due to other banks and customers

The fair value of term deposits payable on demand represents the carrying value of amounts payable on demand as at the balance sheet date. The fair value of term deposits at variable interest rates approximates their carrying values as at the balance sheet date. The fair value of deposits at fixed interest rates is estimated by discounting their future cash flows using rates currently applied to deposits of similar remaining maturities.

32.5. Capital management

The Bank's objectives when managing capital, which is a broader concept than 'equity' on the face of balance sheets, are:

- to comply with the capital requirements set by the central bank;
- to safeguard the Bank's ability to continue as a going concern so that it can continue to provide returns for shareholders and benefits for other stakeholders; and
- to maintain a strong capital base to support the development of its business.

In accordance with the regulations governing this area of monitoring of the Bank's operations, the Bank is obliged to submit to the Croatian National Bank reports on capital adequacy and coverage of capital requirements on a quarterly basis.

Based on the capital requirements from Regulation (EU) 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012, the minimum rate of regulatory capital that the Bank must maintain is 8%, while maintaining a level of capital sufficient to cover the capital requirements of additional tier for capital protection (2.5%) and the additional tier for structural systemic risk (1.5%).

Notes to the financial statements (continued)

for the year from 1 January to 31 December 2017

The table below summarises the structure of regulatory capital and the ratios of the Bank for the year ended 31 December 2017 and 2016.

	31 December 2017 HRK'000	31 December 2016 HRK'000
Regulatory capital		
Share capital	106,924	104,558
Supplementary capital	36,548	34,965
Deductions from regulatory capital	(3,089)	(1,796)
Regulatory capital	140,382	137,727
Structure of risk exposure		
Exposure amount weighted by credit risk	704,040	739,532
Market risk exposure	756	1,204
Operating risk exposure	107,532	99,247
Total risk exposure	812,328	839,983
Structure of capital requirements		
Capital requirements for total capital ratio (8%)	64,986	67,199
Additional tier for capital protection (2.5%)	20,308	21,000
Additional tier for structural system risk (1.5%)	12,185	12,600
Capital requirements for total capital ratio (2017: 2.6%; 2016: 3.09%)	12,121	25,955
Total capital requirements	118,600	126,753
Capital adequacy	17.28%	16.40%

Approval of the financial statements

for the year from 1 January to 31 December 2017

33. Approval of the financial statements

The financial statements set out on pages 23 to 83 were approved by the Management Board of the Bank on 16 March 2018.

Nicola Ceccaroli
President of the Management Board

Ivan Mužić
Member of the Management Board